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To Whom It May Concern:

Re: Application of ESMA's MiFID II Technical Advice on Inducements to Investment Research

SIFMA AMG[1] appreciates the time and consideration the European Commission (the "Commission") has dedicated to considering the global impact of any adjustments to the way dealing commissions are regulated within the European Union (E.U.). From a U.S. perspective, we write to explain the potential impact of the European Securities and Markets Authority (ESMA) December 2014 MiFID II technical advice (the "Technical Advice") to the Commission as it pertains to potential dealing commissions regulation.

SIFMA AMG considers the E.U. approach to dealing commissions of utmost importance because of the high potential for related unintended consequences to spread across the globe and harm investors. We support how the Technical Advice recognizes that investment managers may use the resources of their clients to pay for research. However, we are concerned with the Technical Advice's proposed restrictions on this time-honored practice. The Technical Advice, despite recognizing the importance of allowing clients to finance research, makes such a process nearly impossible from a business perspective. In the Technical Advice, the proposed highly restrictive operational conditions include the proposed requirement for investment managers to obtain written

[1] Our comments represent the views of the members of the Asset Management Group (SIFMA AMG) of the Securities Industry and Financial Markets Association (SIFMA). SIFMA AMG is the voice for the buy side within the securities industry and the broader financial markets in their respective regions. Collectively, the members of SIFMA AMG represent over $30 trillion of assets under management. The clients of SIFMA AMG member firms include, among others, registered investment companies, state and local government pension funds, universities, pension plans, and similar types of retirement funds and private funds, as well as financial institutions, monetary authorities, central banks, provident funds and sovereign wealth funds outside the U.S

agreement to amend the research budget, and the possible misinterpretation of the Technical Advice to effectively prohibit the simultaneous collection of separately determined research funds and execution payments.

With the above in mind, we seek to explain four main points. First, in the United States, the dealing commission process operates under a system of transparency, with legally required disclosures and the option for investors to follow up with further questions. Second, despite an environment in which calls for additional regulation of the financial services sector are routine, there is no indication of any desire to change the regulatory structure of the American commission dealings system.

Third, in addition to a lack of any support to change the way the commission dealings process works in the United States, any major change would likely require the U.S. Congress to pass legislation; there is no quick fix available via a regulatory agency. Finally, and perhaps most importantly, if the E.U were to change the way dealing commissions operate as proposed in the Technical Advice, the dual nature of the compliance regimes would have a potential deleterious effect on the quality of research available within the E.U. It would also harm both smaller and medium-sized research firms and investors, and has the potential to drive financial services business outside of the E.U.

I. The U.S. Commission Dealing Process is Marked by Opportunities for Transparency and a Strong Fiduciary Duty to Act in the Best Interest of Clients

In the United States, financial institutions act as fiduciaries when providing services to their clients, and as fiduciaries, they are under an obligation to act in the best interest of their clients in maximizing the value of clients' assets. SIFMA AMG member firms take their fiduciary responsibilities with the utmost seriousness. In this connection, the procurement of research, whether through dealing commissions or otherwise and in whatever form, is key in helping fulfill member firms' efforts to increase the value of their clients' assets. U.S. investment firms are lawfully permitted, under Section 28(e) of the Securities and Exchange Act of 1934 (the "Exchange Act"), to pay higher execution rates in exchange for research services where the given investment firm reasonably determines that the research services aid the investment firm in the investment decision-making process (i.e., enhance the quality of service provided to clients) and that the higher execution rates are reasonable in relation to the research and brokerage services obtained. Indeed, the current practice in the United States is for investment firms to engage in

commission-sharing arrangements under which dealing commissions from multiple broker dealers are aggregated to permit investment firms to acquire research created by various research firms without regard to the broker whom the investment manager may choose to execute client transactions. Under this system, brokerage and research services are inherently connected.

This legal framework in the United States has operated seamlessly for almost four decades to enhance the quality of services that U.S. money managers provide their clients. It has also consistently driven down commissions and other execution costs, which has been beneficial to investors. For example, in the last seven years (Q1 2008 to Q1 2014), money managers have driven down U.S. equity trading costs by eight percent for high-touch execution and 33 percent for low- touch executions

Furthermore, dealing commission regulations in the U.S. include a host of mechanisms to provide disclosure and transparency to investors. All U.S. investment advisors with over $25 million in assets under management must file Form ADV with the Securities and Exchange Commission (SEC). This disclosure form has two parts. Part 1 contains information on the leadership, organizational structure, and nature of the investment advisor's business. Items 12 and 13 of Part 2 contain extensive disclosure information and describe a financial institution's commission dealing policy.[2] Potential and current investors have the opportunity to examine this policy, ask questions, and often receive any additional information that they may request. As the Commission considers the Technical Advice, SIFMA AMG requests that they keep the option to increase transparency in mind as an alternative approach that has worked well in the United States.

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[2] For example, "if the value of products, research and services provided to an investment adviser is a factor in selecting brokers to execute client trades, the investment adviser must describe in its Form ADV:

I. the products, research and services;

II. whether clients may pay commissions higher than those obtainable from other brokers in return for the research, products and services;

III. whether research is used to service all accounts or just those accounts paying for it; and

IV. any procedures that the adviser used during the last fiscal year to direct client transactions to a particular broker in return for products, research and services received."

See "Disclosure" section in the SEC's office of Compliance, Inspections and Examinations study on the matter in 1998, which can be found here: http://www.sec.gov/news/studies/softdolr.htm.

II. There is No Demand to Change the Way Dealing Commissions are Regulated in the United States

Although the financial services industry faces unprecedented regulatory scrutiny, a push to regulate dealing commissions has not been part of this wave. Since the 2010 passage of the Dodd-Frank Act—under which roughly 250 new regulations need to be written by a least a dozen federal regulators, policymakers and politicians routinely seek to add regulatory obligations in virtually every sector of the financial services industry. But none of the legislative or regulatory actors with jurisdiction over dealing commissions has indicated a fundamental problem with or desire to change the well-entrenched and effective regulatory landscape. In the United States, any legislative change to the way commission dealings is regulated would require support of either the U.S. House of Representatives Committee on Financial Services or the U.S. Senate Banking Committee. Neither committee has indicated any interest in even examining, let alone changing the commission dealing regulation in the foreseeable future.[3]

Outside of the U.S. Congress, the only other government entity that could change the way commission dealing is regulated is the SEC. Again, despite unprecedented regulations in the financial services industry, regulation of dealing commissions is not a priority at the SEC.[4] It should also be no surprise that the SEC does not have dealing commissions on its agenda because the agency has examined and modified its approach to this issue in 1976, 1986, 2001, and 2006 (as well as in more narrowly tailored no-action letters as recently as 2013).[5] To make all four of these modifications, the SEC received and considered input from throughout the financial services industry and beyond.

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[3] In January 2015, the Committee on Financial Services published an oversight plan that included over seventy broad potential areas to examine in the 114th Congress, and there was no mention of Regulation 28(e) or any type of commission dealing topics. The Senate Banking Committee has yet to publish an oversight plan but there is no indication that such a plan would include commission dealings.

[4] *See* the Fall 2014 SEC "Agency Rule List" at http://reginfo.gov/public/do/eAgendaMain;jsessionid=89CCCDF200E37910B0647B2F40895C4A?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235; *See also* the SEC's "Agency Financial Report" that discusses SEC 2015 regulatory priorities yet does not mention dealing commissions.

[5] See *Interpretations of Section 28(e) of the Securities Exchange Act of 1934: Use of Commission Payments by Fiduciaries*, Exchange Act Release No. 12251, (March 24, 1976). In 1976, the SEC issued an interpretive release that excluded products that are "readily and customarily available to the general public as research." Since then, in 1986, 2001 and 2006 the SEC altered the definition of research in ways that would expand the safe harbor as provided in Section 28(e) of the Securities and Exchange Act of 1934. The SEC's office of Compliance, Inspections and Examinations also conducted an extensive study on the matter in 1998, which can be found here: http://www.sec.gov/news/studies/softdolr.htm.

Furthermore, the SEC continues to ensure that investment advisors properly disclose expenses to clients through vigorous enforcement actions against firms with inadequate disclosures.[6]

III. The Only Way to Revamp the U.S. Commission Dealings System is Through Legislation

A. Background

In 1975, commission rates on exchanges became competitive and investment managers became concerned that they would breach a fiduciary duty to their clients if they did not find the lowest price possible to execute a transaction (even if such a course of action was not in the best interest of the client). In response, Congress passed Section 28(e) of the Exchange Act. The legislative history of Section 28(e) of the Exchange Act indicates a specific intent to create "safe harbor" for investment managers to use client funds to finance research expenses.[7] Hearings on Section 28(e) demonstrate congressional intent to create such a safe harbor to encourage free flow of investment research.[8] Even in the SEC's 2005 request for comment on 28(e) safe harbor matters, the agency notes that Congress added Section 28(e) to the Exchange Act "in an effort to address the industry's uncertainties about competitive commission rates," by creating a safe harbor that "provides generally that a money manager does not breach his fiduciary duties under state or federal law solely on the basis that the money manager has paid brokerage commissions

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[6] For example, at the end of 2013, the SEC fined a New York based brokerage firm over $700,000 for failing to properly disclose research expenses to clients and ignoring red flags that research providers were providing improper services. *See* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540557746#.VN6WO4c-BmA.

[7] Section 28(e) of the Exchange Act states:
No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to June 4, 1975, solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

[8] Securities Act Amendments of 1975, Report of Comm. On Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Session 71 (1975).

to a broker-dealer for effecting securities transactions in excess of the amount another broker-dealer would have charged if the money manager determines in good faith the amount of the commission paid is reasonable in relation to the value of the brokerage and research services provided by such broker-dealer."[9]

B. The SEC Cannot Render Section 28(e) Legislation Meaningless

Although, as discussed, the SEC has not indicated any interest in making any major changes to the way research is paid for in the United States, it of course has the authority to make changes to the definition of research through interpretative guidance as it did in 1976, 1986, 2001 and 2006. But any regulatory interpretation or guidance that would result in an effective ban of the commission dealing process and corresponding Section 28(e) safe harbor would likely require a legislative fix. This is because the SEC, as a regulatory agency charged with administering and giving life to a statute by writing rules that interpret the statute, would be bound by several principles of statutory construction. Among these is the principle that it should interpret terms such that no term is rendered meaningless. A landmark U.S. Supreme Court case supports this conclusion, saying, under this "most basic of interpretative canons . . . '"[a] statute should be constructed so that effect is given to all of its provisions, so that no part will be inoperative or superfluous, void or insignificant."'" *Corley* v. *United States*, 556 U. S. 303, 314 (2009) (quoting *Hibbs* v. *Winn*, 542 U. S. 88, 101 (2004)). The legislative history of Section 28(e) indicates that Congress meant to create a safe harbor to allow investment managers to use client funds to pay for research, under appropriate circumstances. Therefore, the SEC could not render such a safe harbor meaningless. Congress would instead have to pass legislation to change the meaning behind and purpose of Section 28(e) of the Exchange Act.

IV. The Technical Advice will Disadvantage the E.U. Financial Community and Its Investor Clients

From a U.S. perspective, the Technical Advice has the potential to harm the research and investment community in the E.U. in several ways. First, European investment firms

[9] Proposed interpretation; request for comment; Securities and Exchange Commission, 17 CFR Part 241 (2005).

and their clients may be disadvantaged relative to investment firms and clients in other jurisdictions. Such potential disadvantage occurs because some broker-dealers do not typically accept cash for research. This is because of uncertainties under U.S. law that could result in the U.S. brokers becoming subject to investment adviser regulation when so doing.[10] Therefore, instead of dealing with such administrative challenges and legal uncertainties, those U.S. broker-dealers who do not accept cash payments for research and are unlikely to change this practice. As a result, this means there is potential to put the E.U. at a comparative disadvantage with the rest of the world when it comes to being able to access research to make investment decisions. It also may deprive European investment firms and their clients of efficient and competitive access to U.S. securities markets, including: (i) capital commitment, volume-weighted average prices and other transactions effected on a principal basis through a broker providing the research; and (ii) investments sold on a dealer-only basis (forcing those European investment firms and their clients into the possibly less favourable agency markets for those investments and potentially jeopardizing best execution).

Second, if enacted, the Technical Advice will harm smaller research firms and therefore decrease the breadth and quality of research available in the global marketplace. For example, if financial institutions need to get specific permission to fund research, there will be a decrease in financing research from lesser-known, smaller firms that have the potential to provide unique and beneficial information to the investing public. Top industry officials note that the regulatory overhaul as proposed in the Technical Advice will result in, "greatly reduced research availability, less research on small and mid-cap European companies, and high costs for asset managers and their clients."[11] Furthermore, as noted by Senator Schumer in the last Senate Banking Committee hearing on this matter, over ten years ago, decreasing funding for research will result in less research information being passed on to small investors themselves. Senator Schumer, who is still a Democratic member of the Senate Banking Committee said, "As many of you have underscored, research is key to our capital markets and it is key for the small investor in particular, because if you are a big investor you can do your own research any way you want, and a small investor cannot."[12]

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[10] Although the SEC staff has provided limited "no action" relief in this area, the relief is unworkable given practical realities.

[11] "Banks forced to Shake Up Analyst Research Business," *Wall Street Journal*, February 10, 2015.

[12] Senator Charles Schumer, Letter to SEC Chairman Christopher Cox, regarding SEC guidance on Section 28(e) (July 20, 2007).

Finally, the Technical Advice has the potential to drive business away from the E.U., which conflicts with recent E.U. policy goals. For example, on February 18, 2015, the E.U. set out a plan to boost capital markets across its 28 member nations. One marching order of the plan tasks the E.U. with devising a course of action, "to identify and remove the barriers which stand between investors' money and investment opportunities, and overcome the obstacles which prevent businesses from reaching investors. We also need to make our system for channeling those funds – the investment chain – as efficient as possible, both nationally and across borders."[13] The Technical Advice lays out a plan that runs contrary to this goal because, as discussed, it will threaten efficient access of E.U. investment firm access to U.S. securities markets. It will also create a disincentive for investment managers, brokers and other research providers to operate within the E.U. If the Technical Advice is enacted, large international firms may lose incentive to conduct business within the E.U. It will not be challenging for some firms to stop establishing new businesses or to conduct current business outside the E.U. to avoid having to retool their approach to research in such a significant manner.

[13] "Building a Better Capital Markets Union", Green Paper, European Commission, February 18, 2015; available at: http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

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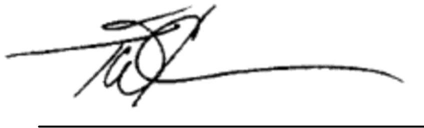
SIFMA AMG recognizes the key role the Commission has in deciding how to go forward in light of the Technical Advice and hopes that we can work together further to find a solution that remains in sync with the global regulation of dealing commissions and therefore best serves investors. Please do not hesitate to contact us should you have any questions or would like to discuss this matter further.

Sincerely,



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