HEALTHY MARKETS ASSOCIATION

A MEMBER ORGANIZATION

April 18, 2022

Via Electronic Mail

Hon. Gary Gensler, Chair
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Research Payment Practices and Expiration of SIFMA No-Action Letter re MiFID II Implementation[1]

Dear Chair Gensler:

The Healthy Markets Association[2] writes to update you on current investment research payment practices and the impacts of the SIFMA No-Action Letter.[3]

Given the extremely negative impact of the SIFMA No-Action Letter on US investors and competition for trading and research services, we urge the Commission to promptly announce its expiration. Additionally, we again urge the Commission to adopt rules or guidance to provide greater clarity for how investment advisers may fulfill their best execution obligations.

SIFMA No-Action Letter

Just before MiFID II's implementation, the SEC staff provided a no-action letter stating the staff "would not recommend enforcement action … if a broker-dealer provides research services … to a Manager that is required to pay for the research services" "from its own money, from a separate research payment account ("RPA") funded with its

[1] Letter from Elizabeth Miller, SEC, to Steve Stone, Morgan Lewis (on behalf of SIFMA), Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm ("SIFMA No-Action Letter").

[2] Healthy Markets Association ("HMA") is a not-for-profit member organization of public pension funds, investment advisers, broker-dealers, exchanges, and market data firms focused on reducing conflicts of interest and improving the transparency, efficiency, and fairness of the capital markets. To learn more about HMA or our members, please see our website at http://healthymarkets.org/about.

[3] This letter supplements our several prior letters to the Commission regarding the need for action to better protect investors by improving investment research payment practices and establishing clear best execution standards for investment advisers. *See, e.g.*, Letter from Tyler Gellasch, HMA, to Hon. Jay Clayton, SEC, Apr. 2, 2018, *available at* https://www.sec.gov/comments/mifidii/cll5-3416684-162181.pdf; Letter from Tyler Gellasch, HMA, to Hon. Jay Clayton, SEC, Dec. 21, 2018, *available at* https://www.sec.gov/comments/mifidii/cll5-4870517-177406.pdf; Letter from Tyler Gellasch, HMA, to Vanessa Countryman, SEC, Mar. 27, 2019, *available at* https://www.sec.gov/comments/265-28/26528-5222036-183706.pdf; Letter from Tyler Gellasch, HMA, Jeff Mahoney, CII, and Kurt Schacht, CFA Institute, to Hon. Jay Clayton, SEC, June 26, 2019, *available at* https://www.sec.gov/comments/mifidii/cll5-5739221-186727 (Joint Letter I); and Letter from Tyler Gellasch, HMA, Jeff Mahoney, CII, and James Allen, CFA Institute, to Hon. Jay Clayton, SEC, Nov. 6, 2020, *available at* https://www.sec.gov/comments/s7-09-20/s70920-7998614-225227.pdf (Joint Letter II).

clients' money, or a combination of the two."[4] In seeking this relief, SIFMA's legal counsel asserted

> Any result that would subject broker-dealers to the Advisers Act regulatory framework when providing research services, …, would be unnecessary in this context given the existing comprehensive regulatory framework governing research services provided by broker-dealers and could disrupt a broker-dealer's role in providing liquidity and acting as counterparty to its clients. SIFMA believes this would create significant uncertainty and likely substantial business disruption.[5]

At root, the SIFMA No-Action Letter was granted in an effort to alleviate concerns that some providers of investment research might withdraw from the US market, rather than sell their investment research products through a regulated investment adviser affiliate.[6]

The feared loss of investment research or trading access for US investors – which drove the issuance of the SIFMA No-Action Letter – simply never materialized. Instead, it is the SIFMA No-Action Letter that has limited competition for trading and research services, while also saddling US investors with greater conflicts of interest and costs.

Many investment advisers believe that their fiduciary responsibilities, including their best execution obligations, require them to separately shop for research and trading services. But beyond regulatory obligations, many US investment advisers believe it is essential to separately shop for these services because their foreign competitors do.

Today, the vast majority of research providers are willing to accept payments for investment research directly from investment advisers or commission aggregators.[7] However, some research providers do not. In the aftermath of the SIFMA No-Action Letter, a handful of large banks have continued to insist that their US-based investment research customers pay for research through trading. As a result, while soft dollars have all-but-disappeared in Europe, the US is a very different story. For example, at Morgan Stanley, the soft-dollar portion of total commissions has increased in recent years.[8]

While these banks have taken different approaches, some banks are even prohibiting their US-based research customers from being able to use commissions generated

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[4] SIFMA No-Action Letter.

[5] Letter from Steve Stone, Morgan Lewis LLP, to Douglas Scheidt, SEC, at 3, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a-incoming.pdf.

[6] SIFMA No-Action Letter (noting that "You are concerned that broker-dealers will not be able to provide research services to Managers, as their receipt of Research Payments may subject the broker-dealers to regulation under the Advisers Act.").

[7] Some prominent investment research providers, including Bank of America, have begun providing investment research through an investment adviser affiliate. See, Peter Smith, *BofA applies to be registered investment adviser ahead of Mifid II*, Financial Times, Oct. 24, 2017, *available at* https://www.ft.com/content/28198e9a-8ff5-365d-8aa0-120b4015da27.

[8] Morgan Stanley, *Commission Wallet Management Trends 1Q22 Review,* April 2022, at 6 (on file with HMA).

from trading at other brokers that may be aggregated and allocated to pay for the research. Thus, in some instances, the only way to pay for research is for a research customer to direct its fund orders to that bank research provider.

This selective, bank-compelled bundling for US-based customers creates significant challenges for the investment advisers who may desire their investment research. Ultimately, the SIFMA No-Action Letter has preserved this bank-compelled bundling regime in the US. This regime harms US investors and markets in several ways, including by:

1. Allowing banks with strong research to effectively preclude US investment advisers from competitively, separately shopping for trading and research services, leading to difficulties in achieving best execution and restrictions on competition in the provision of trading and research services;

2. Putting US investment advisers and their customers (who are compelled to trade to obtain research) at a competitive disadvantage to their European counterparts; and

3. Encouraging investment advisers to use customer assets to generate commissions to pay for research that may not benefit the paying customers, including having US investors pay for research that may benefit exclusively non-US investors.

The SIFMA No-Action Letter Impairs Competition and Best Execution

The small number of banks that are currently compelling US investment advisers to pay for research through trading may not – and often do not – offer the best execution quality. Often, these banks are not at the top of an investment adviser's list of best performing brokers from a trade execution perspective. However, investment advisers may still be compelled to trade with them to gain access to essential research (including corporate access). This means that whomever is paying for the research may be overpaying, because they are also suffering from inferior trading prices. These banks are essentially forcing investment advisers to choose between obtaining research they may need to operate, and best execution for their customers.

But the impacts of this lack of competition for trading services doesn't just harm investors. Bank-compelled bundling also inhibits competition in both the research and trade execution businesses. While some other brokers may provide superior services and execution quality, investment advisers may not have the ability to route their customers' orders to them because the advisers need to use those customer trades to pay a bank that is compelling its research customers to trade with it.

Conversely, the system also harms independent research providers. Some US investment advisers may be tempted to obtain research from banks where they are compelled to use their client funds to pay, rather than obtain research from providers where they may be able to pay directly. Essentially, this decision often determines whether the adviser or the fund customers pay.

The SIFMA No-Action Letter Encourages Cross Subsidization By US Investors

In the US, the beneficiaries of investment research are often not the investors who pay for it. While Section 28(e) permits an investment adviser to factor in the provision of research as a consideration for best execution, the safe harbor has never been tailored to ensure investors know how much they're paying for research, know what they're paying for, or even that they benefit from the payments. This contrasts sharply with the requirements for MiFID II.

Regularly, investment advisers will use trading from one fund or strategy to generate commissions used to pay for research benefiting another fund or strategy – even if they have different investors. For example, an investment adviser seeking research for a small cap fund may not generate sufficient trading activity in that fund to pay for its research. As a result of bank-compelled bundling, an investment adviser may thus be compelled to route orders for *other funds or strategies* (often large cap funds) for execution by that bank. In these instances, investors may pay for the research in heightened commissions and potentially worse execution quality, while not even benefiting from the research in any direct way. Some investment advisers fear that this creates significant concerns regarding both fair treatment of customers and best execution.

Worse, considering that European fund investors are generally not paying for investment research following the implementation of MiFID II, global asset managers are incentivized to shift those research costs onto their other customers who are willing to pay (or are unaware that they are paying for it), which is often their US-based institutional investors and mutual fund customers. This is happening now.[9]

The SIFMA No-Action Letter Puts US Investment Advisers and Investors at a Competitive Disadvantage to European Counterparts

Because of MiFID II, European asset managers are able to freely shop for trading and research services. At the same time, European investors are generally not paying for investment research.

In the US, investment advisers are now compelled by a handful of large banks to trade with them – leading to what are likely to be greater transaction costs and worse trading-related performance for those advisers and their customers.

Further, if a global adviser with European and US customers wishes to treat its customers the same, it essentially can't do it. Some US-based investment advisers

[9] This destructive result was inadvertently amplified by the Commission staff's separate No-Action Letter to permit the aggregation of trades with different commission rates. Notably, we do not believe this No-Action Relief should be rescinded, so long as the SIFMA No-Action Letter is permitted to expire.

have tried hard to do it. For example, some US-based investment advisers have sought to essentially pay directly for investment research (like most asset managers in Europe).

For the vast majority of the research providers they interact with, this may simply take the form of a check from the investment adviser. However, if these advisers seek research from any of the small number of prominent banks that are insisting on bank-compelled bundling, they are essentially compelled to engage in a complex recordkeeping and reimbursement process that is both cumbersome and fraught with legal and compliance risks. The investment adviser may end up writing checks or providing credits to funds and accounts in customer-specific amounts. A European asset manager has none of that complexity or costs.

While we prefer that the SIFMA No-Action Letter be repealed immediately, we recognize that some firms may need to engage in modest legal and business restructuring to accommodate the change. Accordingly, we urge you to announce the expiration soon.

Additional Action Needed

We remind you that there are no Commission rules setting forth best execution expectations for investment advisers,[10] and the only guidance for advisers relates to a statutory exception for investment research.[11] Unlike FINRA's best execution rule for broker-dealers, there are no Commission rules or guidance that detail any specific policies and procedures for investment advisers to have to comply with their best execution obligations.

To assess their best execution practices and performance, many US investment advisers attempt to loosely benchmark their practices against their peers, while fearing Commission second-guessing. Practices vary wildly.

Nevertheless, the Commission's Examinations team released a Risk Alert in 2018 noting that it found deficiencies in investment advisers' best execution practices.[12] We question what these best execution-related deficiencies are measured against, as it certainly isn't clear rules or guidance for investment advisers.

HMA has repeatedly asked the Commission to flesh out and clarify investment advisers' duty of best execution. In 2018, HMA asked the Commission to revise its "Interpretive Guidance" on "fiduciary duty" to provide greater details of what is expected from

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[10] *See* Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, SEC, Aug. 7, 2018, *available at* https://www.sec.gov/comments/s7-09-18/s70918-4182239-172535.pdf.

[11] *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, SEC, Exch. Act Rel. No. 23170 (Apr. 28, 1986); *see also Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934*, SEC, Exch. Act Rel. No. 54165 (July 18, 2006).

[12] *See Risk Alert: Compliance Issues Related to Best Execution by Investment Advisers*, SEC, July 11, 2018, *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf.

advisers regarding their duty of best execution.[13] In 2019, HMA joined the Council of Institutional Investors and the CFA Institute in calling on the Commission to: "revise guidance under Section 28(e) of the Securities Exchange Act of 1934 to: (1) require investment managers and advisers who seek to rely on the safe harbor to disclose amounts paid for research from client assets; and (2) require investment [advisers] who seek to rely on the safe harbor to have procedures to ensure research benefits the asset owners who pay for it."[14] And in 2020, HMA joined the CII and CFA Institute to call on the Commission to revise its fund disclosure rules to require disclosure of (1) transaction costs (not just commissions), including separate line items for costs of investment research paid from fund assets and (2) funds' best execution policies, which should reflect efforts to ensure that fund transaction costs, including commission dollars generated by the fund, directly benefit the asset owners in the fund.[15]

The Commission has not yet taken any of these actions. It should take all of them.

Today, US asset owners generally don't know whether or how much they pay for investment research, even though it may comprise as much as 50% of the total commission costs paid by their funds to some banks that may compel bundling.[16] That lack of transparency – and the abuses it enables – should end.

Conclusion

Because of its ongoing harm to US investors, independent trading firms, and independent research providers, the Commission should promptly announce the expiration of the SIFMA No-Action Letter. While not as time-sensitive, the Commission should also finally provide clear, implementable, and enforceable expectations for how investment advisers can fulfill their duty of best execution. Thank you.

Sincerely,

Tyler Gellasch
Executive Director

[13] Letter from Tyler Gellasch, HMA, to Brent J. Fields, Aug. 7, 2018, *available at* https://www.sec.gov/comments/s7-09-18/s70918-4182239-172535.pdf.
[14] Joint Letter I.
[15] Joint Letter II.
[16] *See, e.g.*, Morgan Stanley, *Commission Wallet Management Trends 1Q22 Review,* April 2022, at 6.