Written Statement of Christopher Nagy, Co-Founder & Research Director of the Healthy Markets Association

Legislative Hearing entitled "U.S. Public Markets Built for the 21st Century: Exploring Reforms to Make Our Public Markets Attractive for Small and Emerging Companies Raising Capital."

U.S. House Committee on Financial Services, Subcommittee on Capital Markets

March 9, 2023

On behalf of the Healthy Markets Association (HMA), I am pleased to submit this Statement in connection with the Subcommittee's March 9, 2022, hearing entitled "*U.S. Public Markets Built for the 21st Century: Exploring Reforms to Make Our Public Markets Attractive for Small and Emerging Companies Raising Capital.*" HMA strongly opposes "discussion draft" legislation[1] noticed in connection with the hearing ("Discussion Draft") that would amend the Investment Advisers Act of 1940 in order to codify a deeply flawed SEC "No Action" letter issued by U.S. Securities and Exchange Commission (SEC) relating to competition for trading and research services.[2] We appreciate this opportunity to explain our concerns to the Subcommittee.

As a preliminary matter, HMA is a not-for-profit member organization focused on improving the transparency, efficiency, and fairness of the capital markets. Healthy Markets promotes these goals through education and advocacy to reduce conflicts of interest, improve timely access to market information, modernize the regulation of trading venues and funding markets, and promote robust public markets. Its members include public pension funds, investment advisers, broker-dealers, exchanges, and data firms.[3] *In short, HMA's members are a cross section of the very market participants who stand to be directly impacted by the legislation.*

As presently constituted, the Discussion Draft would codify the no action relief and create a broad exemption from registration that would be abused. It would cement into place policies that are discriminatory, obsolete, and stand directly opposite to overdue reforms that are necessary to promote the kind of efficient public securities marketplace that is attractive and accessible to small issuers. We appreciate the opportunity to share our perspective with the Subcommittee.

[1] The text of the discussion draft legislation is publicly posted on the HFSC website. https://docs.house.gov/meetings/BA/BA16/20230309/115394/BILLS-118pih-amendtheInvestmentAdvisers.pdf
[2] 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").
[3] A complete list of HMA's members is accessible on the website. https://healthymarkets.org/about-healthy-markets/membership (Accessed 3/16/2023)

I. The Policy Case Against Budding Research and Trading is Overwhelming

Securities firms like *Morgan Stanley* and *Goldman Sachs* typically offer investors potentially valuable "research" as well as "trading services". These firms have long preferred that investors pay for both trade execution and research services with a single bundled commission. Thus, an investment fund, like a public pension plan or a mutual fund, will often be forced to accept a "bundled commission."[4] Beginning a decade ago, however the ground began to shift, when regulators in the United Kingdom undertook a careful review of research payment practices, and identified a myriad of investor harms and market distortions.[5] It became apparent that greater choice and competition could benefit a the vast majority of investors and the marketplace.

MiFID II and Reform

In 2018, MiFID II created a process that would allow investment firms to charge retail customers a separate fee to cover the cost of sell-side research, but the amounts would need to be clearly disclosed and tied directly to research that benefited the customer charged. When the Directive went into effect, very few European firms chose to establish these arrangements. Rather, most European asset managers recognized that the only acceptable way forward was to pay for investment research out of their own funds, using cash payments. Thus,

The SEC No Action Letter and the Proposed Discussion Draft

in 2017, in the months before the implementation of MiFID II, many U.S. securities firms, like *Morgan Stanley* and *Goldman Sachs*, faced a legitimate problem. Many of those firms did business with European clients subject to MiFID II's unbundling requirements. Under MiFID II, these clients needed to be able to start making separate cash payments for investment research.

Recognizing the immediate challenge, the SEC in the Fall of 2017 granted temporary no-action relief, allowing brokers who provide research to accept cash payments as a result of MiFID II without having to register under the Investment Advisers Act.[6] That relief was set to expire in 2020, but the SEC staff ultimately extended the relief for three more years until July 2023.

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.

---

[4] A bundled commission that can be thought of as having two components, a component attributable to the trading (nowadays often less than 1 cent per share), and a component attributable to research services (which can often be as high as 5 or even 10 cents per share). See https://corpgov.law.harvard.edu/2023/02/28/equal-treatment-for-u-s-investors/

[5] At the urging of British authorities, the European Commission concluded that bundled commissions were abusive and often meant that investors did not know how much they were paying their investment advisers.

[6] 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 clients' money, or a combination of the two."

However, 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.

In July of 2022, SEC Division of Investment Management Director William Birdthistle publicly confirmed that the SEC intended to let the no-action relief expire as scheduled. The proposed Discussion Draft would amend the law to prevent the Director's order from taking effect.

II. HMA Strongly Opposed the No Action Letter that Harmed Investors

The SIFMA No Action Relief is unfair and discriminatory.

Since 2017, the SEC's no-action letter has discriminated against U.S. investors. By its terms, the letter applied only to clients subject to MiFID II by law or contract. The relief did not allow securities firms to accept cash payments for research from the vast majority of U.S. investors. As a result, millions of U.S. investors are still paying the cost of bundled research despite not being informed (1) how much they are paying, or (2) whether even whether the research is benefiting them. Worse, in many cases, many asset managers are being compelled to trade with a few brokers to obtain their research, even if they don't want to trade with those brokers.[7]

The SIFMA No Action Relief benefits certain investment banks but there is no evidence that it benefits or reflect the preference of most investors.

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.[8] The reason is that 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.[9]

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

[7] While some large institutions—like the MFS mutual fund complex—had the market power and resources to negotiate workarounds, many U.S. investors were stuck with bundled commissions and securities firms could hide behind the Investment Advisers Act as a reason for refusing to accept cash payments for research service provided U.S. clients, while doing so for European clients (until the cover of the SEC's limited no-action relief).

[8] 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

[9] For example, at Morgan Stanley, the soft-dollar portion of total commissions has increased in recent years. (Morgan Stanley, Commission Wallet Management Trends 1Q22 Review, April 2022, at 6 (on file with HMA).

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.

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

The SIFMA No Action Relief 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.[10]

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.

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.

The SIFMA No Action Relief is total unnecessary and, in many respects, harmful.

Beyond being patently unfair to U.S. investors, the SEC no-action relief causes three distinct problems. First, it distorts best execution practices because it allows securities firms to force investors to accept inferior execution quality in order to obtain research. Second, it encourages

[10] Often, these banks are not at the top of an investment adviser's list of best performing brokers from a trade execution perspective.

asset managers to opt for bundled commissions and thereby to push operating costs onto less sophisticated investors (often, mutual fund investors) without any meaningful disclosures. Third, it forces U.S. investors to subsidize European investors working with global asset managers, who may use U.S. bundled commissions to pay for research costs that then support investments made on behalf of European clients who do not bear a similar charge.

HMA strongly opposes legislation that would create a broad exemption from registration

Given the extremely negative impact of the SIFMA No-Action Letter on US investors and competition for trading and research services, HMA has, among many other commenters, urged the Commission to promptly announce the expiration of the MOU.[11] For the same reasons, HMA would be forced to oppose the Discussion Draft that would essentially codify the SIFMA No-Action Letter should it come to a vote in the Committee.

III. Conclusion

While there are several other steps that the Commission could and should take to improve the transparency of soft dollar payments in the United States, the first and essential step is to let the 2017 no-action relief expire this summer as planned. Equal treatment and investor choice for all investors, foreign and domestic, should be a platform on which Congress strives for.

Thank you again for the opportunity to submit this Written Statement.[12] We appreciate your attention to HMA's views and would be please to provide further assistance.

###

[11] https://healthymarkets.org/wp-content/uploads/2022/04/Letter-to-SEC-re-MiFID-II-Research-Practices-4-18-22.pdf

[12] The perspectives discussed in this Written Statement are supplement extensively by 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).*