August 1, 2014

**Response to the European Securities and Markets Authority ("ESMA")
Regarding Section 2.15 of the Consultation Paper on MiFID II/MiFIR
ESMA/2014/549 (May 22, 2014)**

<u>Section 2.15 (Legitimacy of Inducements to Be Paid to/by a Third Party)</u>

Q79. Do you agree with the proposed exhaustive list of minor non-monetary benefits that are acceptable? Should any other benefits be included on the list? If so, please explain.

No, we do not agree that the proposed exhaustive list of minor non-monetary benefits is acceptable because we are concerned that ESMA's interpretation of Article 24(7)(b) and Article 24(8) of MiFID II as prohibiting the procurement of research with dealing commissions will yield substantially greater costs than benefits for the reasons we discuss below. While we agree that transparency and due regard for the management of conflicts of interest are key in connection with the procurement of research with dealing commissions, we believe that there are less disruptive means by which to achieve these ends in a way that would not degrade the quality of service that investment firms provide to their clients.

Before turning to the substance of our comments, we would like to explain that our comments represent the views the members of the Asset Management Group (AMG) of the Securities Industry and Financial Markets Association (SIFMA) in the United States and of the Asia Securities Industry and Financial Market Association (ASIFMA). 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 AMG represent over $30 trillion of assets under management. The clients of 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.

As asset managers, AMG members 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. 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.

We submit these comments to highlight our concerns that ESMA's interpretation will inhibit the ability of our members to fully assist their clients in maximizing the value of their portfolios. We would welcome the opportunity to meet and collaborate with ESMA personnel to provide them with additional and helpful insights into the workings of the asset management industry, the ways in which research enhances the quality of services that money managers provide to their clients, and the means by which the industry can assist ESMA in meeting its goals and addressing its concerns.

As mentioned above, our disagreement with the proposed exhaustive list of minor non-monetary benefits stems primarily from our concern that ESMA's interpretation of Article 24(7)(b) and Article 24(8) of MiFID II will materially degrade the quality of service provided by investment firms to clients. More specifically, we are concerned that ESMA's interpretation:

1. departs significantly from the Level 1 text and the request for technical advice by the European Commission (Commission);

2. seeks to address a concern over "churning" that may be misplaced because investment firms and clients share a common interest in increasing the value of client assets and, because of this, investment firms have consistently driven down trading costs;

3. may not have considered other means by which to address the concerns identified in the Consultation Paper associated with the procurement of research with dealing commissions;

4. is based on assumptions for which the legal and factual support should be reconsidered;

5. will be anticompetitive to the benefit of larger investment and research firms and at the expense of new and smaller ones which will face increased barriers to entry;

6. will be anticompetitive and have adverse economic impacts in that it will lead to consolidation among research providers, reduce the diversity of research and research viewpoints and constrict the universe of companies and investments covered by research providers – with disproportionate negative effects on small-and-medium sized enterprises (SMEs), which will be deprived of coverage;

7. will cause European based investment firms to be less competitive compared to investment firms located elsewhere and may cause such firms to be denied efficient and competitive access to broker research and securities markets including in the U.S.;

8. will result in increased operational and compliance difficulties for global investment firms;

9. will, as result of the above, materially degrade the quality of service provided by investment firms to their clients; and

10. may not reflect consideration of unforeseen and unintentional consequences which the interpretation will engender.

Rather than viewing research within the framework for minor non-monetary benefits, we believe that research should be viewed as a service that enhances an investment firm's ability to carry out its fiduciary obligations to its clients. We believe that the better approach may be for ESMA to outline a principles-based approach on the manner in which investment firms procure research, including through commission-sharing agreements, rather than prohibit the use by investment firms of dealing commissions to acquire such services.

For ease of reference, we have organized our comments as follows. In Section A, we provide an overview of our understanding of ESMA's interpretation of Article 24(7)(b) and Article 24(8). In Section B, we provide a more detailed explanation of the concerns we mention above. Section C offers alternative means of addressing ESMA's concern over the use of dealing commissions for the procurement of research. As mentioned above, we understand and appreciate ESMA's policy aims, but believe that a collaborative approach with the industry will produce a result that is in the best interest of all stakeholders on this important issue, including clients.

A. <u>Overview of ESMA's Interpretation of Article 24(7)(b) and Article 24(8)</u>

Article 24(7)(b) and Article 24(8) of MiFID II generally state that when an investment firm provides investment advice on an independent basis or portfolio management, the investment firm shall not, among other things, receive and retain non-monetary benefits paid or provided by a third party or person acting on behalf of the third party in relation to the provision of the service to clients. Excluded from this general prohibition, however, is the receipt of minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with a firm's duty to act in the best interest of its clients.

In paragraphs 12 through 16 of Section 2.15 of the Consultation Paper, however, ESMA takes the view that Article 24(7) and Article 24(8) are intended to prohibit investment firms that provide independent investment advice or portfolio management from receiving or obtaining research unless such research is considered a minor non-monetary benefit. Of greatest concern to our members are the statements ESMA makes in paragraph 14 of the Consultation Paper regarding value-added and bespoke research (Enhanced Research):

> [B]ased on the intention of the "minor non-monetary benefits" exemption, ESMA considers that any research that involves a third party allocating valuable resources to a specific portfolio manager would not constitute a minor non-monetary benefit and could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest. For example, it is often common practice for a portfolio manager to agree to higher execution rates to allow them to also obtain higher value research from a broker (i.e. the additional services from the broker are explicitly cross-subsidised by the transaction charges taken from the portfolio manager's client's funds). A firm may also be influenced to direct order flow or "churn" client portfolios to gain access to more valuable research services for "free". As such, any research that is tailored or bespoke in its content or rationed in how it is distributed or accessed would be of a scale and nature such that its provision is likely to influence the recipient's behaviour and cannot be a minor non-monetary benefit. This would include privileged access to

> research analysts (e.g. face-to-face meetings or conference calls), bespoke reports or analytical models, investor field trips, or services linked to research such as corporate access and market data services, which by their nature are limited in access and/or can have a material value.

Separately, Article 24(9) of MiFID II states that investment firms are not regarded as fulfilling their obligations under Article 23 or Article 24(1) where they receive any non-monetary benefit in connection with the provision of an investment service or ancillary service unless the benefit (1) "is designed to enhance the quality of the relevant service to the client"; and (2) "does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients" (collectively, the Quality/Client Interest Principles).

B. CONCERNS OVER ESMA'S INTERPRETATION

1. ESMA's Interpretation Appears to Depart Substantially from the Text of MiFID II and the Commission's Request for Technical Advice

We are concerned that the literal text of MiFID II does not support ESMA's interpretation in paragraphs 12 through 16 of Section 2.15 that research is a non-monetary benefit for purposes of the directive regarding inducements. We believe that the concept of minor non-monetary benefit should instead be confined to those types of non-monetary benefits that, in conformity of laws of many jurisdictions that set requirements in the area, are not related to an investment firm's investment decision-making process and that benefit the investment firm, not its clients.

The provision of investment research should not be treated as a non-monetary benefit as it is more appropriately treated as a service. Annex I of MiFID II explicitly treats research as an ancillary service. The provision of research by a MiFID firm also requires that the recipient become a client of the research provider (art. 4(9) MiFID II). In that respect, it is no different from other investment services, which are purchased by the portfolio manager on behalf of its funds, for the benefit of the underlying asset owner. When read in this context, the prohibition on receipt of non-monetary benefits should not be interpreted as a prohibition of the receipt of investment services, activities or ancillary services (as defined in Sections A and B of Annex I of MiFID 2) when those services are paid for at arm's length and for full value.

Further, a plain reading of Article 24(7)(b) and Article 24(8) does not compel an interpretation of those provisions as prohibiting the use of dealing commissions by investment firms to acquire research or which indicates that research should be viewed within the framework for restrictions on inducements. In the Consultation Paper, ESMA did not provide an explanation regarding the Level I statutory basis which compels or supports the conclusion that the acquisition of research with dealing commissions must be viewed within the framework established for minor non-monetary benefits. In addition, the Commission's request for technical advice does not mention research as a factor that ESMA should consider regarding the definition and conditions for acceptable minor non-monetary benefits.

Importantly, we believe that ESMA's interpretation incorrectly assumes in the case of research that a non-monetary benefit is not "minor" for purposes of the directive if the non-monetary benefit is tailored or bespoke in content or rationed in how it is distributed or accessed. The principle that Enhanced Research cannot be deemed a minor non-monetary benefit is neither stated in MiFID II nor compelled by – or indeed consistent with – the directive's principles of enhancing service quality and acting in a client's best interest. Moreover, research that is tailored or bespoke in content or rationed in how it is distributed or accessed may be *most* capable of meeting the Quality/Client Interest Principles *because* it is limited or unique in the above respects.

The term "minor non-monetary benefit" is not specifically defined in the directive. However, we believe that the concept of a minor non-monetary benefit should be functionally defined by reference to the exclusion from the restrictions on inducements of non-monetary benefits that satisfy the Quality/Client Interest Principles of Article 24(9). Under this framework, so long as the procured research satisfies the Quality/Client Interest Principles, we believe it should be included as a minor non-monetary benefit. When the prohibition on inducements is viewed in this context, the intent of the legislators appears to have been to address inducements that benefit a money manager and not the money manager's clients. We believe that this is reflected in the requirement that monetary benefits be remitted to clients' money accounts. Research, however, does not benefit money managers in the same way as monetary payments because research is procured for the specific purpose of fulfilling a money manager's fiduciary obligations, including to advise clients with care and prudently.

ESMA proposes that the Commission introduce an exhaustive list of non-monetary benefits, but does not explain why it is appropriate to take a prescriptive as opposed to a principle-based approach. The offerings of research services are fluid and dynamic – with types of research always evolving, particularly in changing markets and with advances in technology and communications – such that it is all too easy for an exhaustive list to be too rigid and inflexible. Moreover, a principle-based approach is far more sensible and consistent with the Quality/Client Interest Principles.

In the context of disclosure requirements, the draft technical advice treats monetary payments and non-monetary benefits as the same, including for purposes of disclosing the "nature and amount" and, if the amount cannot be ascertained, "the method of calculating that amount" and supplemental disclosure of the "exact amount of the inducement received on an ex-post basis." We are concerned that this approach is unworkable in the case of research, particularly research provided by brokers on a bundled basis, where there may be no fair market value or necessarily agreed cost or "amount" for the research. This is especially so given that such research may be intertwined with the brokerage services provided by the broker (e.g., provision of market colour, trading ideas and comparable services). Accordingly, it would seldom be possible for investment firms to comply with the proposed disclosure requirements for such research, and any attempt to provide this information could well involve matters of speculation that are problematic for investment firms and not useful for clients.

2. Misplaced Concerns

In the Consultation Paper, ESMA states that the practice of paying higher execution rates to obtain higher-value research from a broker may influence a firm to direct order flow or "churn" client portfolios to gain access to more valuable research for "free." We believe that ESMA's concern is misplaced because investment firms and clients share a common interest in increasing the value of client assets and, because of this, investment firms have consistently driven down trading costs. Specifically, money managers have consistently driven down commissions and other execution costs, which would hardly have occurred if money managers were primarily motivated to increase their commission spending to gain more research. 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. *See* Greenwich Associates, 2014 U.S. Equity Investors Research Study.
- In the last decade (2005 through 2014), money managers have driven down the costs of high-touch executions in Europe by 3.1 basis points and low touch executions by 6.2 basis points. *See* Greenwich Associates, 2014 European Equity Investors Research Study.

The drop in commission rates has also corresponded with an increase use of commission-sharing arrangements – particularly in the U.S. and UK – under which a portion of dealer commissions from the various execution venues to which an investment firm sends its orders may be pooled in a manner that permits the investment firm to procure research from parties other than the brokers who executed given transactions. Under these arrangements, money managers can better negotiate and manage their client commissions, and make trading and research procurement decisions independent of one-another. Moreover, money managers win or lose business – and fees – based on their performance in managing client accounts such that it would not be in a a money manager's best interest to incur added commissions since that would degrade client returns and the money manager's track record.

3. Other Means to Address Concerns

We believe that any concern over churning client accounts to acquire research is addressed in other MiFID II provisions. For example, the Commission has indicated that churning can implicate an investment firm's duty to ensure that a product or service is suitable for a client based on that client's needs. *See* European Commission, ID 845, Investment Services and Activities – Churning (Internal Reference 271) (Date submitted, September 6, 2009). In this connection, Article 25(2) of MiFID II imposes the same suitability obligation on investment firms. Churning would run counter to an investment firm's best execution obligations under Article 27, which requires that an investment firm obtain the best possible result for a client when executing transactions on behalf of the client. Finally, investment firms that provide investment advice and portfolio management have, under Article 24(1), a duty to act honestly, fairly and professionally which, coupled with the requirement under Article 25 to provide significant disclosures to clients, means that investment firms are obligated to act in the best interest of their clients. In short, existing law provide a framework for addressing this concern.

4. Assumptions that Should be Reexamined

ESMA's interpretation appears to be based on the assumption that (i) research and execution are necessarily separate concepts even in the case of research like market colour and advice provided as part of algorithmic trading that seem intertwined with execution services and (ii) the lowest possible commission is always in the best interest of the client. We believe that the factual and legal base for these assumptions should be reexamined. As mentioned above, over the last decade, investment firms have continued to drive down execution costs. As a result, execution venues often have to attract business on a basis other than offering the lowest possible execution costs and, consequently, often compete on the basis of additional services that are provided or bundled into the costs of executing a transaction, such as research in the from market colour, algorithmic trading advice and other enhancements. We believe research is more properly viewed as a service enhancement that execution venues offer as way to distinguish themselves from other firms that offer the same low execution costs.

The fact that research and execution are closely intertwined is illustrated by the fact that there will likely be serious negative consequences involved in changing the current business model – where research providers bear the fixed expenses and risks – to a model that requires managers to pay upfront for research they have not yet been able to evaluate. The current model allows money managers to switch providers of research with no cost and with no downside financial risk if the research no longer meets their clients' needs. The current model works very well by allowing money managers to optimize their research at all times and does not burden their clients with long-term hiring and resourcing decisions that may turn out to be sub-optimal. In addition, the proposal would not increase transparency, but in fact reduce it, since the research costs that are now openly quantified as part of the brokerage allocation process would be embedded in the higher management fees that would inevitably result.

In addition, ESMA's interpretation appears to be based on an assumption that it is in the best interest of a client to seek the lowest commission rates, which we also believe should be reconsidered. Rather, money managers serve their clients' best interests when they seek best execution in connection with clients' transactions, which is not satisfied on the basis of the lowest price, but instead on the quality of the execution given the needs of a particular transaction or investment strategy. Article 27(1) of MiFID II recognizes this point when it states that, in executing orders, investment firms must seek to obtain the best possible *result* that takes into account "price, costs, speed, likelihood of execution and settlement, size, nature and other consideration relevant to the execution of the order." Commission rates represent only a minor part of overall execution quality, as reflected in empirical analyses of best execution. *See, e.g.*, Wayne H. Wagner, *Transaction Costs and Best Execution Compliance and Measurement*, Journal of Trading (Spring 2005).

5. Less Competition

In today's environment, large and small investment firms can use dealing commissions to access a diverse universe of research and research viewpoints from brokers and third parties, which enhances the quality of services which these investment firms can provide to clients. We are concerned that ESMA's interpretation of Article 24(7)(b) and Article 24(8) and the scope of its list of minor non-monetary benefits will result in less competition – to the benefit of larger investment firms and at the expense of smaller investment and research firms, and to the detriment of investors. We also are concerned that the interpretation will reduce the availability of specialized research provided by smaller research institutions and boutiques, thus degrading the quality of services that money managers are able to provide their clients. A reduction in the number of these boutique research firms, we believe, will also reduce coverage of SMEs which are the engines of economic growth. We discuss each point below.

Detriment to Smaller Investment Firms: Smaller investment firms which do not have the financial resources or benefits of in-house research departments will not have the ability to absorb the cost of buying research without the use of dealing commissions. These smaller investment firms could be forced to charge higher fees to their clients to cover their research acquisition costs or bill clients directly for research, which will likely result in the loss of clients, and a reduction in the number of small and independent investment firms that provide independent advice and portfolio management. In addition, prohibiting the use of dealing commissions to acquire research will increase the barriers to entry for new investment firms, especially ones that provide *independent* investment advice and portfolio management.

Loss of Specialized Research: ESMA's interpretation of Article 24(7)(b) and Article 24(8) will reduce the diversity of research and research viewpoints and lead to consolidation among the providers of research at the expense of investor returns. ESMA's interpretation will disproportionately impact smaller and independent research firms because investment firms will have fewer resources by which to acquire their research services. This will threaten the sustainability of many smaller and independent research firms and also raise barriers to entry for new ones. The loss of these smaller and independent research firms will be significant because money managers may no longer be able to access specialized or niche research that can aid in enhancing the quality of services they provide to their clients. In this connection, the broad and extensive availability of all types of research helps to ensure that the markets represent a broad forum of opinions and that securities prices accurately reflect all available information and viewpoints. Small and independent research providers make significant contributions to this broad forum of opinions because they may focus their operations at specific market segments such as SMEs, as discussed below. .

Adverse Impact on Small-and-Medium-Sized Enterprises: We are concerned that ESMA's interpretation will adversely impact coverage of SMEs in a way that will result in less capital being available to these enterprises. In the Consultation Paper, ESMA acknowledges that "[o]ne of the aims of MiFID II is to facilitate access to capital for SMEs." *See* Consultation Paper, Section 6.1. As reflected by the Commission, more than 99% of all European businesses are SMEs and they provide "two out of three of the private sector jobs and contribute to more than half of the total value-added created by businesses in the EU." *See* European Commission, *Facts and Figures About the EU's Small and Medium Enterprise* (last updated May 27, 2013), *available at* http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/index_en.htm. The funding gap for SMEs is already an issue of considerable concern, especially in emerging markets, and we believe than an adoption of ESMA's interpretation will make matters far worse. *See, e.g.*, IOSCO, *Corporate Bond Markets: A Global Perspective* (Staff Research Paper, April 2014). Boutique research firms often take the lead in focusing on SMEs, and the reduction in these firms will result in disproportionately less coverage of SMEs. This lack of coverage will reduce information that money managers and other investors have about SMEs, resulting in a reduction in the capital that will be available to them.

6. European Investment Firms Will Be Less Competitive

In addition to the competitive concerns within Europe between large investment and research firms and smaller ones, we are concerned that prohibiting the use of dealing commissions to obtain many forms of research will generally place European investment firms at a competitive disadvantage to their U.S. and Asian counterparts.

In the U.S., investment firms are lawfully permitted (under Section 28(e) of the Securities and Exchange Act of 1934) 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 U.S. 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. The legal framework in the U.S. has operated seamlessly for almost four decades to enhance the quality of services that U.S. money managers provide their clients.

In Hong Kong, investment firms can use dealing commissions to acquire goods and services if (i) there is a demonstrable benefit to the client; (ii) transactions are executed consistent with a firm's best execution obligations and not in excess of customary full-service brokerage rates; (iii) the client has consented to the receipt of goods and services; and (iv) proper disclosures are made to the client. *See* Rule 13.1 of the Code of Conduct for Persons Licensed or Registered with the Securities and Futures Commission. In Singapore, investment firms may use dealing commissions to acquire goods and services that would assist in the management of unit trusts under similar conditions as in Hong Kong. *See* Paragraphs 3.2(g) and 3.2(h) of The Monetary Authority of Singapore, Code on Collective Investment Schemes (October 1, 2013). As a legal construct, the regimes for the use of dealing commissions in the U.S., Hong Kong and Singapore are not dissimilar to the Quality/Client Interest Principles in Article 24(9). We believe that it would make better sense for ESMA to consider alternative approaches to the use of dealing commissions to procure research that take these regimes into account, since U.S. and Asian securities markets are significant and most large European asset management firms conduct business in these jurisdictions.

Further, European investment firms and their clients will be disadvantaged relative to investment firms and clients in other jurisdictions because U.S. brokers will refuse to provide them with Enhanced Research in exchange for cash payments. 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. While the U.S. Securities and Exchange Commission staff has provided limited "no-action" relief in this area, the relief is unworkable given practical realities. As a result, most major U.S. brokers refuse to accept cash payments for research because of these regulatory concerns, and will likely continue to do so.

Even if U.S. brokers were willing to accept cash payments and submit to U.S. investment adviser regulation over their research, U.S. laws governing investment advisers would result in these brokers potentially limiting their transactions with European investment firms and their clients to pure "low touch" or agency transactions because of U.S. law restrictions on investment advisers effecting principal transactions. This would 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).

7. Operational and Compliance Difficulties

In addition to the challenges faced by investment firms based and located in Europe, we are concerned that ESMA's interpretation will create operational and compliance difficulties for global investment firms that have a presence in Europe.

Today, many global investment firms operate trading and research platforms that are fully integrated and have incurred substantial costs to establish operations in the EU with the expectation that the globally acceptable practice of using commissions to pay for research would continue. If ESMA's interpretation is maintained, operationally, these firms would be challenged to maintain integrated research and trading platforms and would have to develop new and unique order-management systems and trading desks that are separate from their other global operations to handle their European business, and account for the additional prohibitions under European law.

To illustrate this point, global investment firms often aggregate orders for European securities that are made by their European affiliates on behalf of European clients with orders made by their U.S. affiliates on behalf of U.S. clients. These aggregated trades are placed on their European desks to achieve economies of scale and to treat orders from different clients equitably. A trade placed on an execution-only basis by the European affiliate on behalf of the U.S. affiliated money manager would not be subject to European rules on dealing commissions. However, the trade placed by the European affiliate on behalf of its own discretionary managed clients would be. If the European clients paid an execution-only rate, and the U.S. clients paid a bundled rate, it would be difficult to aggregate these into a single trade, with the result being that the trades would likely have to be disaggregated.

Global investment firms facing these issues might be forced to separate – or disaggregate – their trading platforms and practices. This change would degrade the quality of service to clients and would increase the cost of operating EU subsidiaries which is a consequence that ESMA may not have fully appreciated.

For large international firms, the inability to use bundled commissions in Europe would be a significant disincentive to doing business in Europe. Such organizations are by their nature relatively mobile and would potentially relocate from Europe if European rules made it disadvantageous for them to stay. Such larger firms spend significant amounts on dealing commission payments globally. It would not be economically feasible for them to apply stricter European rules on a global basis. Faced with these complexities and compliance burdens, we believe that global investment firms would be more likely to stop operating or establishing operations in Europe.

In addition, because European transactions would have to be handled and traded separately, global investment firms may no longer be able to aggregate client orders on a global basis to take advantage of pricing preferences for larger orders. As a result, European clients of these firms may not receive pricing or executions that are as favourable as those for the U.S. and Asian clients of these firms.

8. Further Examination of the Consequences Required

As outlined above, we believe these issues require a more thoughtful consideration and examination of unforeseen and unintentional consequences. ESMA's interpretation will have far reaching consequences which will substantially impact a broad range of market participants from money management firms and research providers to SMEs.

Although ESMA has indicated that it is preparing an impact analysis and undertaking a data-gathering exercise to support its technical advice, we believe that it would be prudent for ESMA to thoughtfully consider the potential repercussions of its interpretation as well as the unintended consequences of such a fundamental change and then share its data and analysis with the public for a meaningful dialogue before further action is taken. In this regard, even proponents of similar changes have recognized the need for careful assessment of these complex issues. The Investment Management Association (IMA) has acknowledged in connection with a comparable proposal that "[w]hether these theoretical benefits would accrue, and whether they would be counterbalanced by damage in other areas, needs to be assessed in a thoughtful, thorough and measured way. This includes consideration of whether potential negative consequences have substance and whether they can be avoided or mitigated." IMA, The Use of Dealing Commission for the Purchase of Investment Research at 17 (February 2014).

Because global regulations have reached a point of general consistency that facilitates efficient cross border trading, we believe that ESMA should also consider the benefits that the current framework for acquiring research has engendered, from coverage of small and medium enterprises by small research providers to the ability of small and independent investment advisers to compete with larger investment firms with significant resources by which to acquire and product research. In this regard, we suggest that ESMA further consider that its interpretation differs significantly from other jurisdictions with vibrant and liquid securities markets which expressly permit the use of dealing commissions for the procurement of research to enhance the quality of service provided to clients. Indeed, notwithstanding recent amendments to Chapter 11.6 of its *Conduct of Business Sourcebook*, the United Kingdom's

Financial Conduct Authority continues to recognize that dealing commissions can be used to acquire goods and services that reasonably assist a money manager in servicing its clients.

In light of all this, we believe it is imperative that ESMA fully consider the economic impacts of its current interpretation before finalizing it in any form. Not doing so will materially degrade the quality of service provided by investment firms to clients in the long run.

9. Changes in This Area Should Be Implemented on a Global Scale

Although we may differ with aspects of IMA's recommendations on the use of dealing commissions, we join IMA in the conclusion that changes in this area – if they are to be made – should be made on a global scale. As IMA concluded, "IMA is strongly of the view that any proposals to introduce change to the market such that research could no longer be paid for from dealing commission need to be effected on a global basis. Rather than seeking to introduce regional change, say through MiFID, the International Organization of Securities Commissions (IOSCO) would appear to be the natural co-ordinating body." IMA, The Use of Dealing Commission for the Purchase of Investment Research at 18 (February 2014).

C. Alternatives

Rather than view the procurement of research within the inducements regime for minor non-monetary benefits, we believe that investors are best served by a principle-based regime that views research as a service that enhances the quality of services provided to them. In this connection, we believe the framework set out by the Level I text supports viewing research within the conflicts of interest provisions rather than under the inducement provisions. To this end, we believe that investors' interests are best served by permitting investment firms that provide independent investment advice or portfolio management to procure research through the use of dealing commissions under a principle-based approach that encourages the use of commission sharing arrangements. Further, a principle-based approach could be based, in large part, on Article 24(9), which would require that any research procured with dealing commissions satisfy the Quality/Client Interest Principles.

Q80. Do you agree with the proposed approach for the disclosure of monetary and non-monetary benefits, in relation to investment services other than portfolio management and advice on an independent basis?

We have no comments in relation to this question other than to request confirmation that this question does not relate to the procurement of research through the use of dealing commissions.

Q81. Do you agree with the non-exhaustive list of circumstances and situations that NCAs should consider in determining when the quality enhancement test is not met? If not, please explain and provide examples of circumstances and situations where you believe the enhancement test is met. Should any other circumstances and/or situations be included in the list? If so, please explain.

Q82. Do you anticipate any additional costs in order to comply with the requirements proposed in this chapter? If yes, please provide details.

Yes, as discussed below, we believe that there will be substantial costs associated with the requirements of the proposed chapter, and in particular, as a result of ESMA's interpretations of Article 24(7)(b) and Article 24(8).

A. <u>Loss of Small and Independent Investment Firms and Research Providers and Impact on Small and Medium Size Enterprises</u>

Detriment to Smaller Investment Firms: Smaller investment firms which do not have the financial resources or benefits of in-house research departments will not have the ability to absorb the cost of buying research without the use of dealing commissions. These smaller investment firms could be forced to charge higher fees to their clients to cover their research acquisition costs or bill clients directly for research, which will likely result in the loss of clients, and a reduction in the number of small and independent investment firms that provide independent advice and portfolio management. In addition, prohibiting the use of dealing commissions to acquire research will increase the barriers to entry for new investment firms that provide independent investment advice and portfolio management. The continued vitality of small and independent investment firms is important because such firms ensure that investors have sources of unbiased advice since these firms are not controlled by larger investment firms and brokerage houses.

Loss of Specialized Research: ESMA's interpretation of Article 24(7)(b) and Article 24(8) will reduce the diversity of research and research viewpoints and lead to consolidation among the providers of research at the expense of investor returns. ESMA's interpretation will disproportionately impact smaller and independent research firms because investment firms will have fewer resources by which to acquire their research services. This will threaten the sustainability of many smaller and independent research firms and also raise barriers to entry for new ones. The loss of these smaller and independent research firms will be significant because money managers may no longer be able to access specialized or niche research that can aid in enhancing the quality of services they provide to their clients. In this connection, the broad and extensive availability of all types of research helps to ensure that the markets represent a broad forum of opinions and that securities prices accurately reflect all available information and viewpoints. Small and independent research providers make significant contributions to this broad forum of opinions because they may focus their operations at specific market segments such as SMEs, as discussed below.

Adverse Impact on Small-and-Medium-Sized Enterprises (SMEs): We are concerned that ESMA's interpretation will adversely impact coverage of SMEs in a way that will result in less capital available to these enterprises. In the Consultation Paper, ESMA acknowledges that "[o]ne of the aims of MiFID II is to facilitate access to capital for SMEs." *See* Consultation Paper, Section 6.1. As reflected by the Commission, more than 99% of all European businesses are SMEs and they provide "two out of three of the private sector jobs and contribute to more than half of the total value-added created by businesses in the EU." *See* European Commission, *Facts and Figures About the EU's Small and Medium Enterprise* (last updated May 27, 2013), *available at* http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/index_en.htm. The funding gap for SMEs is already an issue of considerable concern, especially in emerging markets, and we believe than an adoption of ESMA's interpretation will make matters far worse. *See, e.g.*, IOSCO, *Corporate Bond Markets: A Global Perspective* (Staff Research Paper, April 2014). Boutique research firms often take the lead in focusing on SMEs and the reduction in these firms will result in disproportionately less coverage of SMEs. This lack of coverage will reduce information that money managers and other investors have about SMEs, resulting in a reduction of the capital that will be available to them.

B. European Firms Will Be Less Competitive

In the U.S., investment firms are lawfully permitted (under Section 28(e) of the Securities and Exchange Act of 1934) 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 U.S. 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. The legal framework in the U.S. has operated seamlessly for almost four decades to enhance the quality of services that U.S. money managers provide to their clients.

In Hong Kong, investment firms can use dealing commissions to acquire goods and services if (i) there is a demonstrable benefit to the client; (ii) transactions are executed consistent with a firm's best execution obligations and not in excess of customary full-service brokerage rates; (iii) the client has consented to the receipt of goods and services; and (iv) proper disclosures are made to the client. *See* Rule 13.1 of the Code of Conduct for Persons Licensed or Registered with the Securities and Futures Commission. In Singapore, investment firms may use dealing commissions to acquire goods and services that would assist in the management of unit trusts under similar conditions as in Hong Kong. *See* Paragraphs 3.2(g) and 3.2(h) of The Monetary Authority of Singapore, Code on Collective Investment Schemes (October 1, 2013). As a legal construct, the regimes for the use of dealing commissions in the U.S., Hong Kong and Singapore are not dissimilar to the Quality/Client Interest Principles in Article 24(9). We believe that it would make better sense for ESMA to consider alternative approaches to the use of dealing commissions to procure research that take these regimes into account, since U.S. and Asian securities markets are significant and most large European asset management firms conduct business in these jurisdictions.

Further, European investment firms and their clients will be disadvantaged relative to investment firms and clients in other jurisdictions because U.S. brokers will refuse to provide them with Enhanced Research in exchange for cash payments. 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. While the U.S. Securities and Exchange Commission staff has provided limited "no-action" relief in this area, the relief is unworkable given practical realities. As a result, most major U.S. brokers refuse to accept cash payments for research because of these regulatory concerns, and will likely continue to do so.

Even if U.S. brokers were willing to accept cash payments and submit to U.S. investment adviser regulation over their research, U.S. laws governing investment advisers would result in these brokers potentially limiting their transactions with European investment firms and their clients to pure "low touch" or agency transactions because of U.S. law restrictions on investment advisers effecting principal transactions. This would 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).

C. Operational and Compliance Difficulties

In addition to the challenges faced by investment firms based and located in Europe, we are concerned that ESMA's interpretation will create operational and compliance difficulties for global investment firms that have a presence in Europe.

Today, many global investment firms operate trading and research platforms that are fully integrated and have incurred substantial costs to establish operations in the EU with the expectation that the globally acceptable practice of using commissions to pay for research would continue. If ESMA's interpretation is maintained, operationally, these firms would be challenged to maintain integrated research and trading platforms and would have to develop new and unique order-management systems and trading desks that are separate from their other global operations to handle their European business, and account for the additional prohibitions under European law.

To illustrate this point, global investment firms often aggregate orders for European securities that are made by their European affiliates on behalf of European clients with orders made by their U.S. affiliates on behalf of U.S. clients. These aggregated trades are placed on their European desks to achieve economies of scale and to treat orders from different clients equitably. A trade placed on an execution-only basis by the European affiliate on behalf of the U.S. affiliated money manager would not be subject to European rules on dealing commissions. However, the trade placed by the European affiliate on behalf of its own discretionary managed clients would be. If the European clients paid an execution-only rate, and the U.S. clients paid a bundled rate, it would be difficult to aggregate these into a single trade, with the result being that the trades would likely have to be disaggregated.

Global investment firms facing these issues might be forced to separate – or disaggregate – their trading platforms and practices. This change would degrade the quality of service to clients and would increase the cost of operating EU subsidiaries which is a consequence that ESMA may not have fully appreciated.

For large international firms, the inability to use bundled commissions in Europe would be a significant disincentive to doing business in Europe. Such organizations are by their nature relatively mobile and would potentially relocate from Europe if European rules made it disadvantageous for them to stay. Such larger firms spend significant amounts on dealing commission payments globally. It would not be economically feasible for them to apply stricter European rules on a global basis. Faced with these complexities and compliance burdens, we believe that global investment firms would be more likely to stop operating or establishing operations in Europe.

In addition, because European transactions would have to be handled and traded separately, global investment firms may no longer be able to aggregate client orders on a global basis to take advantage of pricing preferences for larger orders. As a result, European clients of these firms may not receive pricing or executions that are as favourable as those for the U.S. and Asian clients of these firms.