INVESTMENT ADVISER ASSOCIATION

July 31, 2014

Via Electronic Mail

Mr. Steven Maijoor
Chair
European Securities and Markets Authority
103 rue de Grenelle
75007 Paris, France

Re: ESMA Consultation Paper: MiFID II/MiFIR (May 2014)

Dear Mr. Maijoor:

The Investment Adviser Association (IAA) appreciates the opportunity to comment on ESMA's Consultation Paper regarding the new Markets in Financial Instruments Directive (MiFID II) and the measures relating to the legitimacy of inducements paid to/by third parties.[1] Specifically, we address the practice of certain investment managers agreeing to execution rates from brokers that include financial research as part of the brokers' overall services (dealing commissions).[2] The IAA is a not-for-profit U.S. association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. Our membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment funds, endowments, foundations, and corporations. Many of our member firms manage, or have affiliates that manage, assets for European clients.[3]

Investment advisers in the U.S. are subject to a fiduciary standard in the management of their clients' assets, which encompasses the important principles of trust, loyalty, and duty of care. Our members must act in the best interests of clients and place the interests of clients before their own. This duty is over-arching and includes transparency, particularly the duty to disclose and mitigate, among other things, potential conflicts of interest that may arise in the course of their services.

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[1] MiFID Level 1, Article 24(8); ESMA Consultation Paper, Section 2.15, pp. 118-125.

[2] As used in this letter, the term "dealing commissions" refers to "soft" commissions (or "soft dollars" as referred to in the United States), bundled brokerage, or commission sharing arrangements.

[3] For more information, please visit our website: www.investmentadviser.org.

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We commend ESMA for considering these important issues and support efforts to strengthen investor protections and increase clarity for clients. We agree with ESMA that regulations should ensure that investors are accurately informed about potential conflicts, including all fees, commissions, and benefits the investment firm may receive from third parties in connection with providing investment services. We have concerns, however, about ESMA's proposed interpretations that would appear to effectively ban the use of dealing commissions by global investment managers to obtain investment research on behalf of their EU clients. Obtaining research from dealing commissions in order to promote the interest of clients should not be deemed a *per se* "inducement" under MiFID II. The IAA believes that such arrangements, when properly structured and disclosed, are beneficial for clients and do not impair a manager's duty to act in its clients' best interest. We also believe that potential conflicts inherent in dealing commission arrangements can be addressed through increased transparency and robust disclosure. This would allow investors to make choices about these arrangements that are appropriate for them.

Our comments below relate primarily to: (1) ESMA's proposed narrow interpretation of the term "minor non-monetary benefits" as it relates to financial research; (2) the implications of ESMA's proposals for investment managers that do business on a global basis, and (3) the additional costs that would be imposed on market participants in order to comply with the proposed requirements.

Introduction

MiFID II places restrictions on the ability of investment firms providing investment advice on an independent basis and portfolio management (hereinafter referred to collectively as "managers") to accept and retain fees, commissions, or any monetary or non-monetary benefits from third parties. However, MiFID II provides an important exemption for certain "non-monetary benefits" that are: (1) deemed "minor;" (2) clearly disclosed to the client; (3) capable of enhancing the quality of the service provided; and (4) do not, or could not be judged to, impair the ability of investment firms to act in the best interest of their clients. As noted in the Consultation Paper, MiFID II contemplates that the receipt of minor non-monetary benefits should be permitted for "all MiFID investment and ancillary services, not only for independent advice or portfolio management" in accordance with the conditions outlined in MiFID II.

The Consultation Paper discusses the potential for financial research purchased by independent managers to be permissible as a minor non-monetary benefit. ESMA states that the exemption should be narrowly construed and proposes that only financial research that is intended for a large number of persons or for the general public be permitted (i.e., widely-disseminated, generic research that is generally not of high value). ESMA also states that such benefits should only qualify as "minor" where they are "reasonable and proportionate and of such scale that they are unlikely to influence the recipient's behavior in any way that is detrimental to the interests of the relevant client."

The Consultation Paper further suggests that any research involving a third party allocating valuable resources to a specific portfolio manager "could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest" and thus considers such non-monetary benefits to not be "minor" for purposes of the exemption. ESMA, in particular, singles out the practice of portfolio managers agreeing to higher execution rates in exchange for "higher value research" from a broker. ESMA states that this practice intrinsically impairs compliance with the portfolio manger's duty to act in its client's best interest. ESMA's proposed interpretations would thus appear to be a *per se* ban on dealing commission arrangements by independent managers to obtain useful research regardless of whether it is in the client's best interest. In effect, ESMA has determined that such arrangements are, by default, ***not*** in the client's best interest. For the reasons set forth below, the IAA disagrees with this blanket assertion.

ESMA Should Reconsider its Proposed Narrow Interpretation of Minor Non-Monetary Benefits

The IAA is concerned that ESMA's proposed interpretation of the term minor non-monetary benefit could effectively ban dealing commission arrangements that are beneficial to clients, consistent with the managers' duty to act in their client's best interest, and reasonably proportionate to the overall fee being charged to the client (i.e., if the commission were to be "unbundled," the costs associated with the research component would be "minor" relative to the execution costs). In our view, such an interpretation would go beyond the conditions outlined in MiFID II.

Dealing commission arrangements may benefit investors by facilitating the ability of investment managers to obtain important information and analysis that assists with their investment decisions. These arrangements provide managers with a broad range of financial information that can be used to make more informed investment decisions for their clients. We note that these types of arrangements are especially beneficial to clients of smaller managers who may not be able to provide certain in-house research on a cost efficient basis. While we recognize that there are potential conflicts of interest in such arrangements, we believe that the ability of clients to receive these services should not be limited to the receipt of widely-disseminated generic research that is of little value. Rather, the determination of what is appropriate within the MiFID II guidelines should be at the discretion of managers, bearing in mind their obligations to act in their clients' best interest.

The IAA believes that potential conflicts inherent in dealing commission arrangements can and should be addressed through clear disclosure to clients, combined with adoption and implementation of policies and procedures designed to ensure that such arrangements are beneficial to the client and that they will not impair the manager's duty to act in the client's best interest. We also note that, consistent with their duty to seek best execution, managers may decide to place a lower value on broker research while agreeing to pay a commission that is higher than available elsewhere because they value the overall execution services that the broker provides. In addition, we note that investment managers already have incentives to manage transaction costs, including dealing commissions, due to the direct impact such costs have on investment returns – which are of primary importance to clients.

The IAA actively supports full and fair disclosure of the use of client commissions for research and brokerage services under U.S. law. As a fiduciary, a U.S. investment adviser has an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interest to existing and prospective clients. The duty of best execution requires an adviser to seek to execute securities transactions for clients in such a manner that the client's total cost or proceeds is the most favorable under the circumstances. In addition to enhanced disclosure requirements, we support efforts to clarify the types of products and services that constitute permissible research under applicable law and encourage the preservation of third-party research to the extent it is in the best interest of clients.

Market Implications for Managers Doing Business on a Global Basis

ESMA's proposals would, in effect, require independent managers to "unbundle" dealing commission arrangements and would represent a significant change for the global market. Due to the global nature of asset management and the supply of execution and research goods and services, many investment managers operate their businesses and provide their services on a global basis. ESMA's proposals could result in standards that would not be consistent with those of other jurisdictions, including the U.S., and would require advisers to substantially change their global compliance infrastructures to accommodate EU-specific requirements, to the likely detriment of EU clients or international clients using EU managers.

The IAA is also concerned these proposals could adversely impact the overall level of research coverage in the international market and the competitiveness of the EU markets in particular. A wholesale ban on obtaining research through dealing commissions would put EU managers at a competitive disadvantage to their counterparts in the U.S. and Asia. For example, if "unbundling" were only required in the EU, firms that increase their asset management fees for EU clients to offset costs for obtaining financial information separately would be perceived as charging higher management fees than their international competitors.

The establishment of EU rules that differ from other jurisdictions could also disadvantage EU clients, and/or discourage investment managers from offering their services in the EU. For example, many managers place their orders for securities transactions on a "block" basis, which generally benefits their clients, and orders from EU firms may be aggregated with orders from non-EU affiliates in a group that uses a fully integrated trading and research platform.[4] This practice aims to achieve economies of scale and to treat orders from different clients equitably. If the commissions related to these orders were deemed impermissible for MiFID II purposes, managers may feel compelled to separate out EU clients from these otherwise advantageous arrangements. If EU rules are not harmonized with those in other jurisdictions, the result could disadvantage EU clients, and present practical, logistical, and client relations issues. It could also lead to EU clients engaging non-EU managers to avoid these disadvantages.

In the alternative, investment managers may decide not to take on EU clients if they determine that they cannot provide the same benefits to EU clients as they can provide to other clients. Either result could ultimately disadvantage EU clients. Under certain circumstances, managers may not be able to effectively "ring fence" the arrangements for EU clients without potentially negative consequences.

The proposed changes could also affect smaller managers who may not be able to develop certain in-house research and are forced to pay increased prices for research from external providers. We submit that this could ultimately lead to a reduction in the number of asset managers, which would limit the choice available to EU investors.

Cost Implications of ESMA's Proposed Interpretations

ESMA's proposed interpretations also would impose additional costs on market participants in the EU. Specifically, ESMA's proposed interpretations would effectively mean the "unbundling" of financial research from dealing commission arrangements, except for the most generic, widely available commentary. However, ESMA offers no cost-benefit analysis of effectively requiring managers to separately purchase high value research on behalf of clients. We submit that that the costs associated with the proposals would be substantial relative to any perceived benefits. For example, global managers would have to implement specific compliance procedures to satisfy EU-specific requirements. Moreover, even for EU managers there would be substantial cost associated with setting up compliance procedures to unbundle. We note also that there may be logistical challenges from the sell side in meeting these arrangements which could further increase the costs associated with these proposed interpretations.

ESMA's proposals are based on the assumption that there either is or will be an established market for every service with a "hard" cost. However, we believe that this information is not currently readily available and that it is possible that brokers may not be

[4] Under EU regulations, aggregation is permitted where: (1) it is unlikely that the aggregation will disadvantage the client; (2) it is disclosed to the client, including the fact that the aggregation may work to its disadvantage; and (3) an order allocation policy is established and effectively implemented. See e.g., Articles 48 and 49 of the MiFID Implementing Directive.

willing or able to provide this information. We note that the proposed changes would affect only the responsibilities of independent managers, and not impose any obligations on the brokers providing the research to disclose information concerning pricing. In addition, some brokers may not cooperate in providing a value or even accept payments from an investment manager's own resources for such services. Even if brokers provided estimated prices for these services, prices among brokers would inevitably vary, depending on the methodologies and assumptions underlying the estimates. Thus, we are concerned that managers would face difficulties in documenting compliance with this unbundling requirement, because brokers do not have an established or consistent means for valuing research.

We are also concerned that the proposal could result in a reduction of research available in the market. For example, certain research topics may no longer be covered because brokers may not deem it profitable to provide this information. These topics are likely to be in the less mainstream areas where smaller managers may operate, again increasing the burdens that would be imposed on such managers. Moreover, a reduction in the number of differing views about stocks could have an overall negative impact on market liquidity. This could disproportionately affect small cap issuers as it would not be economical for managers to pay a "hard" cost for specialist research on such companies.

There may also be an increase in the administrative expense of tracking payments for research on an ongoing basis (separately and apart from the broker's commission) in an effort by the manager to document the overall execution rate. Furthermore, the increased compliance burdens under the proposal would fall disproportionately on small and medium-sized managers that may rely more heavily upon external research.

In addition, even if advisers declined to receive proprietary research along with execution services from brokers, there are no assurances that commission rates would be reduced proportionately. The current arrangements are cost-effective for end investors as they allow managers to obtain a wide array of research while paying reasonable commissions in relation to the value received. The effect of an up-front charge for all research (other than minor generic research) would be to reduce the amount of research to which managers have access without necessarily decreasing costs. Thus, paying "hard dollars" for research without a correlating decrease in the execution rate would mean an overall increase in fees for clients without any additional benefits.

If ESMA determines to proceed with its proposed recommendations, we request that ESMA impose an explicit requirement on brokers to provide information to managers regarding the costs of the associated research or other products and/or services provided along with the execution costs. We submit that unless this requirement is in place, it will be costlier for managers to comply with the proposed new obligations and there may be little or no benefits passed onto clients. We believe that better transparency by brokers and disclosure of costs would be more cost-effective in mitigating the conflict of interest stemming from the use of dealing commissions to acquire external research. More transparency from brokers would also permit investment managers to implement better controls and compliance infrastructures regarding commissions paid to brokers.

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The IAA agrees it is important for clients to know about any conflicts of interests that may be present in the dealing commission arrangements of their investment managers. We respectfully submit that allowing market-driven decisions by investors on the basis of fully transparent disclosure is a more appropriate and cost-effective way to address the goals of the MiFID II inducement measures than eliminating the use of dealing commissions. Thus, we urge ESMA to reassess its proposed interpretations relating to inducements and minor non-monetary benefits. We urge ESMA to clarify that, with respect to all research, investment managers have the opportunity to assess whether their particular dealing commission arrangements enhance the quality of services for clients, whether they have adequately disclosed such arrangements, including any potential conflicts of interest that may be present, and whether their ability to act in the best interest of their clients would be impaired. Finally, we recommend that ESMA provide independent managers affected by the proposed changes sufficient time to assess the impact of the rules on their business models and implement related compliance controls.

We appreciate the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Karen L. Barr, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Sanjay Lamba
Assistant General Counsel