

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

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Mohamed Ben Salem
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International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

Re: Comments on CR06/2015 - Elements of International Regulatory Standards on Fees and Expenses of Investment Funds

Dear Mr. Ben Salem:

The Alliance in Support of Independent Research is pleased to have this opportunity to comment on the issues addressed in Consultation Report CR06/2015 relating to soft commissions on transactions.

Background of the Alliance in Support of Independent Research

The Alliance in Support of Independent Research is a group of broker-dealers in the United States who furnish independent research and other services to investment managers. Members of the Alliance share a common interest in fostering a favorable regulatory environment in which research services and products may be furnished to the money management community, and in preserving the umbrella of protection Section 28(e) of the Securities and Exchange Act of 1934 provides to fiduciaries who receive all forms of investment research in the U.S. A primary goal of the Alliance is to promote the observance of proper standards under the securities laws for disseminating research and achieving best execution of portfolio transactions for managed accounts.

The leading members of the Alliance include the following broker-dealers:

Capital Institutional Services, Inc. (CAPIS)
Kristi P. Wetherington, Chief Executive Officer

The Interstate Group
A division of Sterne, Agee & Leach, Inc.
Grady G. Thomas, Jr., President
Jay Thomas, Chief Operating Officer

ConvergEx Group/Westminster Research Associates LLC
Timothy P. O'Halloran, Co-President
Christopher Tiscornia, Co-President

We believe our members are involved in a significant portion of the arrangements in the U.S. under which fiduciaries such as mutual funds, investment advisers, banks and other money managers are provided with research services and products for the benefit of their managed accounts.

The Alliance's Comments

The Alliance supports IOSCO's continued recognition of the benefits of soft commission arrangements¹ as well as IOSCO's approach of addressing the regulation of soft commission arrangements through a focus on best execution, effective compliance procedures and appropriate disclosures.

As detailed below, our experience in the U.S. is that client commission arrangements under Section 28(e) are an essential tool in ensuring that asset managers have an efficient avenue to access a variety of research products that assist them in making investment decisions for their clients.

Client Commission Arrangements in the U.S.

In the U.S., the provision of investment research by broker-dealers has been an acceptable business practice for over 200 years, with research being a natural component of the securities execution process. In 2006, after an extensive study of market conditions and industry practices, and after receiving

¹ "The 2007 report did recognize that the financing of investment research by [portfolio managers] was an accepted and widely used mechanism; and that, soft commission arrangements – notably the provision of investment research – could provide benefits to . . . investors if conflicts of interest are appropriately managed." Consultation Report at 17, Paragraph 78.

comments from seventy-one commenters representing investors, asset managers and broker-dealers, the U.S. Securities and Exchange Commission (“SEC”) issued an interpretative release regarding client commission arrangements that discussed regulatory standards for compliance and disclosure which closely align with those set forth in CR06/2015.² Since the 2006 Release, the U.S. securities markets have flourished. Competitive pressures and business practices in the U.S. have led broker-dealers who provide independent research services to fiduciaries to produce and deliver customer statements indicating the cash value of the research provided to the customer and the commissions used to pay for the research. This type of transparency and accountability has made the research dissemination process more efficient and has benefited fiduciaries and their accounts by bringing them accurate cost and benefit information. While proprietary research arrangements³ do not have the same level of transparency, U.S. fiduciaries use a variety of methods to confirm that the value of the research and execution services they receive on behalf of managed accounts is reasonable in relation to the commissions charged.

Benefits to Investors from Research-Commission Arrangements

Investors in the U.S. reap a number of benefits from the research-commission arrangements described above:

Flow of Research Services to Money Managers

One of the principal objectives of Congress in adopting Section 28(e) was to ensure “the future availability and quality of research and other services”⁴ to the investment community. Broker-dealers in the U.S. now provide literally hundreds of research services to money managers to assist in the investment decision-making process. The vast majority of these research services have only become available to money managers since the adoption of Section 28(e) in 1975.

The Section 28(e) safe harbor has been particularly useful in fostering the development of independent research providers. Independent research providers are often small operations targeted at a specific segment of the market which is not given sufficient coverage by full service firms. These firms often generate research through innovative and unique methodologies. It is extremely

² Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, SEC Rel. No. 34-54165 (July 18, 2006) (“2006 Release”).

³ An arrangement where the research is produced internally by the executing broker-dealer.

⁴ S. Rep. No. 94-75 (1975).

difficult for a small independent research provider with a limited marketing budget to gain a foothold in the market for investment research. Section 28(e) arrangements allow these firms to rely upon and obtain assistance from broker-dealers in exposing their products to the market. In turn, these broker-dealers provide independent research and execution services that benefit many investors and serve as a vehicle for the provision of investment research through the portfolio execution process.

Competition Among Broker-Dealers Providing Research Has Reduced Execution Costs in the U.S.

By becoming major competitors for institutional order flow, research brokers have exerted downward pressure on commission rates. In the past seven years, blended U.S. equity trading costs for institutional orders have fallen by eighteen percent, including a reduction of thirty three percent for “low touch” executions and a reduction of eight percent for “high-touch” executions.⁵

Smaller Asset Managers Have Benefited From the Favorable Regulatory Environment for Providing Research in Conjunction with Execution

Many startup investment managers cannot establish their businesses and compete against larger money managers (who command large fee bases from which they can sustain in-house research) without access to the research services that broker-dealers provide for portfolio commissions. Section 28(e) has facilitated small firms’ entry into the investment advisory business. Included in this category are firms that may not have significant capital resources but have been able to obtain the technology-oriented research and other investment services with which to compete with larger firms for access to ideas and strategies.⁶

How Investors Are Assisted By Research-Commission Arrangements

A money manager’s receipt of research services from a broker-dealer for commissions occurs under the statutory guidelines of Section 28(e). The conditions of Section 28(e) coverage were fashioned so as to protect investor

⁵ See Greenwich Associates, 2014 U.S. Equity Investors Research Study.

⁶ These observations were confirmed by a 1998 SEC Staff Inspection Report. Smaller advisers generating less than \$100,000 in commissions used over 50% of their commissions for research. This can be contrasted with larger money managers generating more than \$100 million in commissions, which used only 8% of their commissions for research.

assets and insure that research obtained with client commissions is used for the benefit of the investor.

Current U.S. Disclosure Requirements

Current SEC disclosure requirements for advisers have also worked to protect investors' assets in research-commission arrangements. Even where such an arrangement falls within Section 28(e), the SEC requires a registered investment adviser to disclose its use of client brokerage commissions to receive research on its Form ADV in sufficient detail for clients "to understand the types of products or services [the adviser is] acquiring and to permit [clients] to evaluate possible conflicts of interest."⁷ Registered investment companies are required to make similar disclosures in their registration statements. In addition, as noted above, broker-dealers who offer third party client commission arrangements provide monthly statements detailing the research services provided, their cash value, and the amount of the commissions used to pay for research and execution services.

Comments on Specific Issues Raised in Consultation Report CR06/2015

Managing Potential Conflicts of Interest Regarding Soft Commission Arrangements

The Alliance generally supports the approach taken by CR06/2015, particularly the focus on monitoring satisfaction of relevant best execution requirements and adopting policies and procedures to oversee the use of soft commission arrangements. The Alliance does suggest that IOSCO reconsider the language in the Consultation Report that suggests that soft commissions "should not be the sole or a primary criterion when a CIS operator chooses an intermediary to perform or arrange execution."⁸ In the U.S., all broker-dealers are required to satisfy best execution standards when executing trades, and asset managers are also subject to best execution standards when determining where to place trades for managed accounts. Because of these regulatory obligations, and the relative transparency and efficiency of the U.S. securities markets, there are often a number of broker-dealers who are equally capable of offering best execution for a particular securities transaction. As such, it is common for broker-dealers to compete based upon the investment research that can be provided to an investment manager, and it is common for an investment

⁷ Form ADV: Part 2A Item 12 A. 1.

⁸ Consultation Report at 17, Paragraph 75.

manager, once determining that best execution standards will be met, to make the receipt of research a primary criterion in determining where to execute customer trades. Because best execution principles must always be satisfied, and because investment research is obtained to assist in the investment-decision making process on behalf of managed accounts, the Alliance believes that it is entirely appropriate for investment managers to use, where appropriate, the receipt of investment research as a primary criterion when choosing an intermediary to perform or arrange an execution.

The Consultation Report also requests comments concerning whether a list of forbidden or permitted goods and services is an effective tool for regulating soft commission arrangements. Our members' experience in the U.S. is that a principles based approach, supplemented by a list of "forbidden" goods and services, and a non-exclusive list of permitted goods and services, is an efficient regulatory standard that provides guidance to industry participants, protects investors, and encourages the development of innovative investment research to the benefit of investors and the market. The Alliance strongly opposes the use of an exclusive list of "permitted" goods and services. Such a list would stifle innovation as it would discourage research providers from developing new products that would have to be added to the "permitted" list. It would also place an unnecessary ongoing strain on national securities regulators, who would have to continually monitor and update the list of "permitted" services in response to developments in the investment research market.

Disclosure of Soft Commission Arrangements

The Alliance generally supports the Consultation Report's suggestions regarding disclosure of soft commission arrangements, and notes that they are substantially similar to existing U.S. provisions regarding the disclosure of Section 28(e) arrangements. One word of caution. Requiring the disclosure to investors of the names of brokers used by the money manager and the commission payments made to such brokers may entail the disclosure of proprietary information, which could be exploited by competitors and others. Such information, if made public, could negatively impact a money manager's portfolio execution process, as managers often attempt to achieve anonymity when executing large block transactions.

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We hope these comments are helpful to IOSCO in assessing its standard of good practice for soft commission arrangements. We would be pleased to answer any questions you may have on this matter.

Sincerely,

The Alliance in Support of Independent Research

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