

THE ALLIANCE IN SUPPORT OF INDEPENDENT RESEARCH

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Wholesale Conduct Policy Team
Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
Great Britain

*Re: Comments on Discussion Paper 14/3 – Discussion
on the use of dealing commission regime*

Dear Sir or Madam:

The Alliance in Support of Independent Research is pleased to have this opportunity to comment on the issues addressed in Discussion Paper 14/3 (DP 14/3) relating to bundled brokerage and soft commission arrangements.

Background of 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

We note that DP 14/3 identifies a number of situations where parties to bundled brokerage arrangements in the UK are taking steps to ensure that appropriate value is received for client commissions used to obtain research. Many of the instances cited in DP 14/3 involve commission sharing arrangements (CSAs) fostered by the FSA's 2006 rules on the use of dealing commissions. Notwithstanding these positive findings, DP 14/3 suggests that banning bundled brokerage arrangements would benefit investors, investment managers and independent research firms. The Alliance strongly disagrees with

this suggestion. 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. We respectfully suggest that the FCA consider continuing to work with UK asset managers and brokers where it perceives the need to strengthen the transparency and oversight of client commission arrangements, rather than seeking to end these arrangements.

Client Commission Arrangements in the U.S.

The debate currently taking place in the UK and Europe is similar to the debate that took place in the U.S. from 2002 to 2006, where certain parties asked that unbundling take place through the repeal of Section 28(e). In the U.S., bundled research has been an acceptable business practice for over 200 years, with research being a natural component of the securities execution process. The idea of removing or restricting Section 28(e), the legal underpinning of bundled proprietary and third party research, was rejected in the U.S.

Since 2006, 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 the fiduciary and its accounts by bringing them accurate cost and benefit information. While proprietary research arrangements¹ 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”² 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.

¹ i.e., arrangements where the research is produced internally by the executing broker-dealer.

² S. Rep. No. 94-75 (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 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 benefits many investors.

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.³

³ See Greenwich Associates, 2014 U.S. Equity Investors Research Study.

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.⁴

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

⁴ 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.

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."⁵ 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 (equivalent to CSAs in the UK) 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 Discussion Paper 14/3

Transparency and the Ability to Monitor Bundled Brokerage Arrangements

Many of the issues raised in DP 14/3 involve the alleged lack of transparency in bundled brokerage arrangements and the difficulty of monitoring such arrangements. It is important to note that DP 14/3 expressly acknowledges that CSAs are inherently transparent, particularly as to the cost of research, and can be easily structured to permit investment managers and clients to closely

⁵ Form ADV: Part 2A Item 12 A. 1.

monitor the efficacy of such arrangements.⁶ Further, DP 14/3 acknowledges that brokers offering non-CSA bundled arrangements have the ability to price their research.⁷ Accordingly, if there has been any failure by some to appropriately monitor CSAs or non-CSA bundled arrangements in the UK (which DP 14/3 alludes to but does not support with any empirical evidence) this alleged failure cannot be attributed to the fundamental nature and structure of such arrangements. Further, DP 14/3 misses the larger point. The investment management industry in the UK and worldwide is highly competitive, and investment history and performance is the primary metric used by investors to compare managers. An investment manager that does not closely monitor and manage its commission costs against the value of brokerage and research services received will underperform vis-à-vis its competitors. This subpar performance will not go unnoticed by the manager's clients and potential clients.

Effect of Bundled Brokerage Arrangements on Investment Performance

On the topic of investment performance we note that DP 14/3 cites a "recent study on U.S. mutual funds" to support the notion that bundled brokerage arrangements are a form of "opaque costs" that are "detrimental to performance."⁸ A review of this study reveals that it cannot be relied upon to

⁶ See DP 14/3 at 3.12, 3.13, 3.17 and 4.23.

⁷ See DP 14/3 at 4.53 – 4.56.

⁸ DP 14/3 at 5.51 (citing Edelen, R. Evans, R.B. and Kadlec, G.B., 'Disclosure and agency conflict: Evidence from mutual fund commission bundling', *Journal of Financial Economics*, Volume 103, Issue 2, February 2012, Pages 308–326) (hereinafter the "Evans Kadlec Study").

support the proposition that bundled brokerage arrangements involving the distribution of research are harmful to investment performance. In this regard, the study only purports to review the effect on investment performance of “bundled” arrangements related to mutual fund distribution expenses, and specifically excludes a review of “bundled” research-commission arrangements.⁹ Bundled mutual fund distribution arrangements (which have been banned in the U.S.) involve a mutual fund manager compensating a broker-dealer for marketing and selling the mutual fund’s shares by executing trades with the broker-dealer. The service being provided as part of a bundled mutual fund distribution arrangement (sale of fund shares) is not used by the manager to make investment decisions for the fund and does not directly benefit the fund or its investors. In contrast, in a research-commission arrangement a manager may only obtain research that assists in the investment decision-making process, the goal of which is to maximize performance. This important distinction belies the suggestion that research-commission arrangements negatively impact performance. In fact, more directly relevant empirical research suggests a correlation between CSA-type research-commission arrangements and enhanced performance.¹⁰

⁹ Evans Kadlec Study at 309.

¹⁰ Stephan M. Horan & D. Bruce Johnsen “Can third-party payments benefit the principal? The case of soft dollar brokerage, 28 Int’l Rev. L. & Econ. 56 (2008) (“Our database of private money managers shows premium commissions are positively related to risk-adjusted performance, suggesting [CSA type arrangements] benefit investors.”) Id. at 56, Abstract.

Competitive Impact of Banning Bundled Brokerage Arrangements

We disagree with several unsupported findings made in DP 14/3 regarding the competitive impact of banning bundled brokerage arrangements. For example, DP 14/3 suggests that banning bundled brokerage arrangements will increase the availability of third party independent research.¹¹ As set forth above, our experience in the U.S. is that small and newly formed independent research firms rely extensively on broker-dealers to serve as distribution channels for their research, and thus we believe third party research firms in the UK would be harmed if they could not distribute their research through CSAs, resulting in a diminution in the availability of independent research. This would be especially harmful to investors in small and mid-cap securities, because issuers of such securities are especially reliant on independent research firms for research coverage. Even large broker-dealers with sizable research departments would likely have their research departments reduced or eliminated if their research could not be offered through bundled brokerage arrangements.

DP 14/3 also underestimates the effect banning bundled brokerage arrangements would have on smaller investment managers. The release appears to concede that smaller managers might be hurt in the short run, but allegedly not in the medium to long run.¹² Our experience in the U.S. is that

¹¹ See DP 14/3 at 5.50.

¹² See DP 14/3 at 5.54

smaller money managers have smaller research budgets, are more reliant on research-commission arrangements, and would thus be disproportionately affected if bundled brokerage arrangements are banned.¹³

We also believe that DP 14/3 greatly underestimates the impact on UK or other European investment managers if ESMA or the FCA determines to ban bundled brokerage arrangements.¹⁴ Contrary to the suggestion in DP 14/3 that “investors prefer local managers”¹⁵ the investment management industry is becoming more global rather than localized and will continue to move in this direction. We are confident that U.S. investment managers will continue to rely on the Section 28(e) safe harbor to receive research services that benefit their clients and improve their investment performance, and that international clients will continue to seek out these managers.¹⁶

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We hope these comments are helpful to the FCA in formulating policies regarding bundled brokerage arrangements. We would be pleased to answer any questions you may have on this matter.

¹³ See supra fn. 3.

¹⁴ DP 14/3 at 5.57.

¹⁵ Id.

¹⁶ We note that Section 28(e) is only subject to amendment by Act of Congress. We know of no effort being made to amend or modify Section 28(e), which has functioned successfully for almost forty years.

Sincerely,

The Alliance in Support of Independent Research

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