



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 17

MEETING DATE: December 20, 2017

SUBJECT: Education on Markets in Financial Instruments Directive II (MiFID II) and Presentation of Manager Research Budgets and Soft Dollars Audit

SUBMITTED FOR: Consent Deliberation and Action Receive and File

RECOMMENDATION

Staff recommends that the Board receive and file the following report and related attachments providing education on Markets in Financial Instruments Directive II ("MiFID II") and presenting the results of an audit of soft dollar practices of SCERS' investment managers performed by Zeno Consulting Group.

PURPOSE

In accordance with authorization provided by the Board, approved under the Delegation of Authority to the CEO policy, Staff has engaged the services of Zeno Consulting Group ("Zeno") to audit the soft dollar practices of SCERS' investment managers. The purpose of this report is to provide background and discussion on soft dollar practices and MiFID II, the need to audit SCERS' investment managers related to their soft dollar practices, and the results of the audit performed by Zeno.

BACKGROUND

Zeno Consulting Group is a highly regarded boutique consulting firm that specializes in working with plan sponsors and pension plans in the monitoring and evaluation of transactional services provided by asset managers and brokers. Some of the products and services provided by Zeno include trading cost analysis, manager transition services, and fiduciary audits. As you may recall, SCERS previously utilized the services of Zeno to audit the soft dollar practices of SCERS' investment managers in 2013-2014. SCERS has also retained Zeno in the past to audit SCERS' foreign exchange transaction costs, in addition to utilizing Zeno to assist with several manager transitions.

Staff and Zeno presented the results of the previous soft dollar audit at the September 2014 Board meeting, which included information on the definition of soft dollars, the use of soft dollar trading and commissions by investment managers, the need to audit soft dollar practices of managers, and the benefit it provides to SCERS. The following background discussion will highlight the key points from the previous analysis presented as well as provide an update on current regulatory developments and the need to perform a current audit.

Investment managers compensate brokerage firms for their services through commission revenue. The term “soft dollars” refers to trading commissions generated by investment managers through the use of soft dollar trades (also called ‘directed trades’). This is in contrast to paying brokerage firms directly (i.e. ‘hard dollars’). Investment managers will utilize directed trades to generate soft dollar commissions as a way to compensate brokerage firms for research and related services. Using commissions via soft dollars to pay for research is a way for investment managers to acquire these services without having to pay for them directly. Instead, these costs are born by the investors in the fund. The commission dollars that an investment manager pays to a brokerage firm (for research or execution services) are the assets of the investors, therefore, the investment managers have a fiduciary responsibility to obtain best execution on trades and prudently use commission dollars for the benefit of the investor. The purpose of the audit is to ensure that SCERS’ investment managers are applying best practices and meeting fiduciary obligations when utilizing soft dollar arrangements with brokers.

While it is common for investment managers to utilize soft dollars and the practice is permissible under Section 28(e) of the Securities Exchange Act of 1934 (“Section 28(e)”), the use of soft dollars has been under substantial scrutiny and regulatory authorities have established specific rules governing their use. Soft dollar trading commissions are often higher than trading commissions generated on non-directed, execution only trades, which is permissible under Section 28(e) provided that the investment manager has made a good faith determination regarding the reasonableness of the commission paid and also meets best execution standards. Within the Investment Management Agreement (“IMA”) contract for SCERS’ separate account investment managers, SCERS includes language related to the manager’s use of soft dollars. This language authorizes the investment manager to utilize SCERS’ commissions for securing supplemental research and other services permitted by Section 28(e), subject to best execution and the manager’s determination that such research is in the best interest of SCERS. In addition to regulatory guidance provided under Section 28(e), other financial market institutions, such as the CFA Institute, have issued ethical and best practice standards on the use of soft dollars.

The use of soft dollars is more prevalent across some investment products and categories versus others. For example, it is more common for an active small cap equity manager to use soft dollars in exchange for research compared to an active large cap equity manager. Small cap stocks generally have less sell-side research coverage (compared to large cap stocks) which makes brokerage research more valuable. While most active managers utilize some level of brokerage research, it is typically used as a complement to a manager’s internal research teams, which provide the bulk of research used in the investment process. For example, larger investment firms (as measured by assets under management) generally have

greater internal resources which can be used to generate their own internal research and thus do not require as much externally generated research from brokerage firms. This is consistent with the quarterly trading cost analysis performed by Elkins-McSherry on behalf of SCERS, which has shown that SCERS' active small cap equity managers generally have higher commission costs, as measured in cents per share, compared to active large cap managers.

In contrast to soft dollar arrangements directed by investment managers, SCERS also participates in a commission recapture program, which is administered by State Street Global Markets ("SSGM") on behalf of SCERS. Commission recapture dollars are completely separate from soft dollars. A commission recapture program is an arrangement where an institutional investor like SCERS directs their investment managers to execute a percentage of the manager's trades through a specific 'commission recapture' broker. SSGM maintains a network of brokers who are included in their commission recapture program. As investment managers direct trades through an approved commission recapture broker, the institutional investor is rebated a portion of the commission rate paid by the investment manager. During calendar year 2016, approximately \$113,000 in commissions were directed through SCERS commission recapture program, which was approximately 11% of all equity commissions dollars spent by SCERS. SCERS' commission recapture program generated approximately \$62,000 in commission rebates during calendar year 2016, reducing SCERS' overall equity trading commission costs by approximately 6%.

The discussion above highlights that investment managers have multiple options for executing trades including: execution only (non-soft dollar or 'hard dollar'), soft dollar trades, and trades directed through SCERS' commission recapture program. Given these various options, each investment manager must make a determination how to execute a trade, the relevant benefit to SCERS and the allocation of SCERS commission dollars. While commission recapture trades benefit SCERS by lowering overall trading costs, soft dollar trades benefit investment managers by helping to cover the cost of brokerage and research services. However, soft dollars also indirectly benefit investors by providing research that managers utilize to generate greater investment returns.

Given the multiple options that SCERS' investment managers have for executing trades, and the changing regulatory environment around the use of soft dollars (discussed below), Staff concluded it was appropriate to perform an audit of the soft dollar and research budget practices of its investment managers. The goal of the audit is to both evaluate the current soft dollar and research spending of SCERS' managers and better understand the manager's policies and procedures in advance of the changing regulatory environment. Zeno has specific expertise in performing fiduciary audits, including the use soft dollars, and as previously mentioned, has been retained by SCERS in the past including the previous soft dollar audit performed in 2014. The cost of the current audit performed by Zeno is \$30,000 and was approved under the SCERS policy which delegates authority to SCERS' CEO to execute contracts under \$50,000.

RECENT REGULATORY DEVELOPMENTS – MiFID II

There have been recent regulatory developments in the financial markets that will have a significant impact on the use of soft dollars by both international and U.S. based investment managers. The existing European Union (“EU”) legal framework governing financial markets is being replaced by a revised directive and new regulation. The *Markets in Financial Instruments Directive II* and *Markets in Financial Instruments Regulations*, together referred to as “MiFID II”, was issued in July 2014 and is scheduled to take effect on January 3, 2018. While MiFID II institutes a wide range of changes to the regulatory framework for financial markets in the EU, the overall goal of MiFID II is to provide increased standards for investor protection and greater market transparency across financial services institutions. To accomplish its intended goals, the key provisions of MiFID II include:

- **Research Unbundling** – MiFID II establishes new rules around the use of client commissions to acquire research. The rules essentially prohibit the use of soft dollars for all managers subject to MiFID II. **The change requires managers to make a determination to either (i) pay for research themselves directly using ‘hard dollars’ or (ii) request and receive approval from clients to pay for research, establish a pre-agreed upon budget, provide detail of research services purchased, and establishing a Research Payment Account (RPA) to track research payments.** For firms that make requests of clients to pay for research, payment may be made directly using hard dollars collected from assets (i.e. research fee as a percentage of AUM) or using a transactional method attached to trading commissions with a specified amount dedicated to fund the RPA. This process will make explicit the specific costs for research provided by brokers and purchased by asset managers on behalf of their clients. As described by the regulations, aside from a limited number of exceptions, the rules apply to all forms of research across various investment products (equity, fixed income, etc.) and includes written notes and calls/meetings with analysts.
- **Best Execution & Broker Due Diligence** – MiFID II places an increased focus on best execution including requirements to provide evidence, monitoring and additional disclosure. The formalization of best execution requirements places increased emphasis on managers to perform due diligence on broker execution capabilities. However, the combination of greater scrutiny on best execution and the changing economics of unbundled execution commission rates is likely to result in a reduction in the number of executing brokers in the marketplace.
- **Trade and Transaction Reporting** – MiFID II places additional reporting requirements on market participants including an increase in the amount and granularity of data provided, the timeliness of reporting executed trades, and requirements to report client data including Legal Entity Identifiers (“LEIs”) used to identify clients for whom trades are executed. SCERS has already begun to receive requests from its managers regarding data necessary to meet the new reporting requirements.

MiFID II is promulgated by the European Securities and Markets Authority (“ESMA”) and only directly applies to financial market participants in the EU and United Kingdom. The determining factor for the application of MiFID II is based on whether the investment manager

has operations located in the EU or UK. For U.S. based investment managers that are regulated by the SEC, MiFID II regulations do not directly apply. However, while not formally subject to MiFID II, there are still considerable ramifications for global and U.S. based firms. Some of the considerations for these institutions include:

- **Global Firms**
 - Should they implement a standardized policy that applies across the firm or maintain different policies for EU and non-EU offices and clients. There have been different approaches to this issue by global firms that range from announcing a global policy to cover all research costs versus only covering research costs for locations directly subject to the provisions of MiFID II.
- **U.S. Firms**
 - U.S. based firms with EU clients may face requests to comply with MiFID II despite not being formally subject to the regulation.
 - Determining how investment managers will apply their policies across their client base when faced with differing regulatory regimes.
 - MiFID II prohibits the use of client assets to subsidize the research costs of another client (if both are subject to MiFID II regulation), however, U.S. clients need to monitor their managers to ensure that commissions of U.S. clients are not used to subsidize the research costs of EU and UK clients.
- **Use of Hard Dollars for Research Prohibited in U.S.**
 - Current regulations in the U.S. prohibit a U.S. broker-dealer from accepting hard dollar payments for its research from an investment manager. This creates a conflict for global firms who, to comply with MiFID II, plan to establish hard dollar research budgets for EU and UK clients subject to MiFID II but cannot follow the same policy for U.S. clients.
- The graphic below, as presented by BofA Merrill Lynch, highlights the global impact of MiFID II and some of the considerations described above:

MiFID II Impact

- **MiFID II research rules focus on global research consumption of EU asset managers BUT have global consequences:**
 - 43% of US asset managers are planning changes to research evaluation processes ⁽¹⁾
- **“Unbundling” may mean different things to different managers e.g. CSAs vs. transparent budgeting/spend vs. full application of MiFID II**

Global Model	“Ring-fenced” model
Apply unbundling across all global operations: <ul style="list-style-type: none"> ▪ Transparent budgeting process ▪ Uniform application of research payment model(s) depending on asset-class mix ▪ Compliance with RPA governance requirements for sweeping and ring-fencing funds ▪ Full disclosure of research expenditure 	Clear boundaries separating regional operations: <ul style="list-style-type: none"> ▪ Only apply MiFID II budgeting and disclosure rules to European activity ▪ Clear separation of research consumption, including tracking, between regions ▪ Separate payment models used in different regions e.g. hard-dollar in Europe/fully bundled in US

Considerations for model selection:

- **Investor pressure** to align with best practice e.g. because large proportion of EU-based investors
- **Global books** managed jointly between EU and non-EU PMs vs funds/strategies geographically separate
- **US research consumption:** proportion of US research consumed globally, esp. by PMs jointly managing funds/strategies
- **Choice of payment model:** Hard \$ research payment incompatible with rules in other jurisdictions (US, Japan, South Korea)

12 (1) Greenwich Associates 2016 MiFID II Unbundling and Research Budgeting Study

ZENO CONSULTING, SOFT DOLLAR & RESEARCH BUDGET AUDIT RESULTS

As discussed above, Zeno was hired to audit the soft dollar and research budget practices SCERS' external equity and fixed income managers, including the potential impact of MiFID II. The process included Staff sending letters to the managers requesting them to complete a questionnaire, designed by Zeno, to capture the information necessary to evaluate the managers' use of client commissions. The information requested of the managers included:

- *The total budgeted amount for research and estimated research charge;*
- *The total costs that each respective client will be assessed for that research;*
- *If the research is paid with client commissions, the unbundled portion of the commissions attributed to the client's research charge;*
- *A description of the specific research received by the Manager;*
- *The amounts paid to each Broker and Research Provider from the Fund's account, as well as the aggregate total of all other accounts, for research*
- *Any soft-dollar commission commitment or target.*

Zeno worked with SCERS' investment managers to get the questionnaires completed in a timely manner. Upon completion, Zeno was able to evaluate and provide an assessment of the research budgeting process and commission practices, on both an aggregate and individual fund level, for SCERS' managers. While the level of transparency and disclosure varied among the managers, on an aggregate basis, some of the key findings were:

- SCERS accounts represented 4% of the investment managers overall assets under management (AUM).
- Over half of SCERS' investment managers (52%) used SCERS assets (soft dollars) to purchase research.
 - 11 out of 16 Equity managers (69%) examined used fund assets for research.
- The aggregate commissions paid by the investment managers analyzed totaled \$777,000 or approximately 2 basis points of AUM (for the managers analyzed).
- On average, 29% of total commissions generated by managers (\$229,000) were used to purchase research.
- The percentage of commission dollars used by managers to purchase research (29%) was less than the typical manager reviewed by Zeno.
 - One possible explanation for the low use of soft dollars is the participation by SCERS' managers in its Commission Recapture program.
- ***SCERS' portion of total research costs was approximately 3% of total investment product research costs. Therefore, the amount of SCERS' commission assets used for research was slightly lower than SCERS' percentage of overall AUM (4%).***
- For the investment managers that provided adequate or better levels of transparency in their responses, Zeno concluded that none of them spent a disproportionate amount of fund assets on research, relative to the Fund's portfolio value.
- The investment managers utilized a diverse set of research providers:

Number of Research Providers	
Bulge Bracket:	81 (36%)
Non-Bulge Bracket:	394 (42%)
Independent Research Providers:	158 (20%)
Expert Networks:	2 (3%)

- Zeno prepared a comprehensive report on the audit, which will be used by Staff, Verus and Zeno to follow up with SCERS’ investment managers. As part of the report, Zeno prepared a Manager Compliance/Fiduciary Oversight Report Card, which provides an overall assessment of each manager’s research budgeting process and highlights where there are compliance oversight issues recommended for additional follow up. It is worth noting that areas for recommended follow up may be due to lack of disclosure and require additional information versus a direct violation of compliance. The Report Card is below and is included in the attached Zeno report.

Manager Compliance/Fiduciary Oversight Report Card

Manager	Investment Mandate	Overall Assessment of Research-budgeting Process					Compliance/Fiduciary Oversight Issues					Additional Best Practices		
		Overall Research Process	Level of Disclosure Transparency	Uses Fund assets for research	Will be MiFID II Compliant	Applies MiFID II standards to US clients	Client Cross-subsidize	Broker Vote vs. Ex-ante Res. Budget	Unspent research balances	Unbundle Comm.	Manager pays for other clients	Buys Non-research services	Research Provider List	Tracks Research Use
Baillie Gifford	Emg. Mkts All Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	○	●	N/D
Brandywine	Global Fixed Income	3 rd Quartile	Adequate	No	Partially	No	●	N/A	N/A	N/A	N/A	N/A	●	●
Brigade Capital	Opportunistic Credit	3 rd Quartile	Limited	No	Yes	Partially	●	N/A	N/A	N/A	N/A	N/A	●	●
Brown Advisory	US Large Cap Growth	2 nd Quartile	Adequate	Yes	Partially	No	●	●	●	○	●	○	●	○
DGHM & Co LLC	US Small Cap Value	2 nd Quartile	Superior	Yes	No	No	●	●	●	○	●	○	○	●
Eagle Capital Mgmt	US Large Cap Core	2 nd Quartile	Superior	Yes	Partially	No	○	●	●	●	●	○	○	●
Huber Capital Mgmt	US Large Cap Value	2 nd Quartile	Adequate	Yes	No	No	●	●	●	●	●	○	○	○
JP Morgan Inv. Mgmt	US Large Cap 130/30	4 th Quartile	Deficient	Yes	No	No	●	●	●	○	●	○	●	○
Lazard Asst Mgmt.	Non US All Country	2 nd Quartile	Robust	Yes	Partially	No	●	○	●	●	●	○	○	○
LSV Asset Mgmt.	Non US All Country	3 rd Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
M.A Weatherbie Capital	US Small Cap Growth	2 nd Quartile	Superior	Yes	No	No	●	●	●	●	●	○	○	●

Manager	Investment Mandate	Overall Assessment of Research-budgeting Process					Compliance/Fiduciary Oversight Issues					Additional Best Practices		
		Overall Research Process	Level of Disclosure Transparency	Uses Fund assets for research	Will be MiFID II Compliant	Applies MiFID II standards to US clients	Client Cross-subsidize	Broker Vote vs. Ex-ante Res. Budget	Unspent research balances	Unbundle Comm.	Manager pays for other clients	Buys Non-research services	Research Provider List	Tracks Research Use
Mondrian Inv. Part.	Emg. Mkts All Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Mondrian Inv. Part.	Emg. Mkts. Small Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Mondrian Inv. Part.	Intl Dev. Small Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Neuberger Berman	US Aggregate Bond	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
Prudential Glob. Inv. Mgmt.	US- Core Plus	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
TCW	US- Core Plus	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
UBS	US Small Cap Growth	3 rd Quartile	Deficient	Yes	Yes	Partially	○	○	●	○	N/D	○	●	●
Walter Scott & Part. LTD	Non US All Country Growth	4 th Quartile	Limited	Yes	Yes	Yes	●	●	●	●	●	○	○	○
Wedge Cap. Mgmt. LLP	US Small Cap Value	2 nd Quartile	Robust	Yes	Yes	No	●	○	●	●	●	○	○	○
William Blair & Co.	Non-US All Country	2 nd Quartile	Adequate	Yes	No	Partially	○	○	●	●	N/D	○	●	●

○	Acceptable Performance
●	Recommend Follow-up
N/A	Manager was unable/unwilling to provide data

RECOMMENDATIONS AND FOLLOW UP ITEMS

Upon completing the audit, Zeno noted over 60+ items across all SCERS' managers for potential follow up. As noted previously, several of the items related to transparency and inadequate disclosure, which will require additional communication from the managers to clarify their research budgeting policies and their approach to MiFID II, which is effective January 2018. Zeno provided a detailed list of recommended items for each manager.

On a summary level, there are key areas for follow up that apply across a number of SCERS' managers. As described above, the implementation of MiFID II requires specific policy changes by investment managers to claim compliance as well as additional areas for SCERS to follow up on to ensure that SCERS is not disadvantaged by managers not subject to MiFID II (compared to other EU clients or managers subject to MiFID II). Areas for further follow up include:

- Ensure that managers are following policies that are in the best interests of SCERS and applying Most Favored Nation ("MFN") clauses, as applicable.
 - Several managers noted that to comply with MiFID II the manager would cover the cost of European clients, however, they did not intend to cover the research costs of U.S. clients such as SCERS. Staff will evaluate this approach against MFN clauses that are contained within SCERS' Investment Management Agreements to determine if there are any conflicts/violations.
- Evaluate the managers intent to cross-subsidize research costs of other clients.
 - MiFID II explicitly restricts a manager's ability to use the fund assets of one client to subsidize the research costs for other clients. For managers that intend to have clients pay for research under MiFID II, the manager must establish research budgets and receive permission from managers to use their assets to purchase research. Follow up is necessary to determine how a manager will cover the research costs for clients that do not provide consent to directly pay for research.
 - While cross subsidizing research costs is allowed under U.S. law, it violates MiFID II and the best practices it establishes. Follow up is required for the managers that intend to continue to use soft dollars in the U.S. and the application of the policy across their client base.
- Evaluate future use of both soft dollar and hard dollar spending on research.
 - For managers that intend to cover the costs of research using their own P&L, evaluate the level of spending on future research to ensure they have adequate resources to meet the needs of the investment strategy.
 - It is worth noting that several of SCERS' managers already use their internal assets to fund research needs and stand to benefit from potential declines in the cost of research.
- Formally request that all of SCERS managers that are subject to MiFID II regulation, apply MiFID II standards and principles, as they relate to the soft dollar and research expenditures, to SCERS' account.

SUMMARY

Overall, the audit performed by Zeno uncovered some issues that need to be addressed by individual managers, specifically as they relate to the changing regulatory landscape. As the MiFID II regulation has yet to become effective, there are varying levels of preparedness across the investment management landscape. The audit was well timed to highlight to managers the importance that SCERS places on best practices regarding soft dollars and the potential to influence manager policies as the regulatory environment surrounding soft dollar and research spending evolves. Under the current regulatory policies, SCERS' investment managers spending on research, via soft dollar commissions, is in line or below that of other comparable managers.

Zeno will be present at SCERS' Board meeting on December 20th, along with Staff, to provide education on soft dollars and MiFID II, review the results of the audit, and to answer any questions.

ATTACHMENT

Zeno Consulting, Sacramento County Soft Dollar and MiFID II Presentation, December 2017

Prepared by:

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Reviewed by:

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Chief Executive Officer



A New Fiduciary Duty:
Manager Research Budgets and Soft-dollars

Presentation to: Sacramento County Employees Retirement System
December 20, 2017



Why are we here today?

- Massive new regulation in Europe and the UK known as the Markets in Financial Instruments Directive (MiFID II), has changed the permissible ways that managers can use commissions (from practices that have been in place for almost 50 years). Managers with operations and clients in Europe are subject to MiFID II.
- ***Important Note:*** while US managers providing US strategies are not subject to MiFID II, global managers (who are subject to MiFID II for other clients) have to decide whether they will use only one standardized policy for all of their clients. In those instances, US clients may be approached as well, and need to ensure they are not being disadvantaged vs their manager's European clients!
- Beginning January 3, 2018 this will have a significant “*ripple effect*” for US asset owners:
 - **New fiduciary duties** (and risks), on an annual basis, for plan fiduciaries.
 - **New investment risks** for asset managers – to be monitored closely by consultants and Plan Investment Officers.
 - **Much greater transparency** into your managers' processes (for those asset owners who care).
 - **Potential cost savings**, for asset owners who pro-actively monitor and work with their managers to ensure full compliance with the new regulations.

But before discussing these implications further, a little background is needed...



What are “Soft-dollars” and what is their role re: Research?

Aside from using commissions for trade execution, Managers often execute the Fund’s trades through certain brokers and pay a higher commission rate than normal (out of Plan assets). In return, the broker provides the manager with credits the manager can subsequently use to purchase brokerage and research services *for the benefit of the manager* (akin to “frequent flyer miles”).

Important! This is NOT “Commission Recapture” (where managers send trades to specific brokers so that the asset owner receives a commission rebate).

- In the US, Soft-dollars are permissible under Section 28 (e) of the Securities and Exchange Act of 1934. However, while managers are allowed to pay higher than normal commission rates (i.e. “pay up”) for soft-dollar services, the managers’ overall costs must still meet “best execution” standards.
- Further, since commissions are considered to be “Plan assets,” asset owners have a duty to monitor them, and the right to limit, and/or prohibit the purchase of soft-dollar services with the Plan’s commissions.
- Operational, administrative, and marketing-related services are not permissible purchases.



What does MiFID II do?

MiFID II changes everything! A Sea Change!

- Soft-dollars are banned for all managers subject to MiFID II.
- To buy research under MiFID II a manager has only two choices:
 - Use their client's money pursuant to stringent new rules; or
 - Use the manager's own money.
- If managers want to use their clients' money, MiFID II now requires that:
 - Managers must identify specific research needs for each respective strategy.
 - Total research costs for each respective strategy, are allocated to clients on a pro-rata basis (e.g. Portfolio AUM).
 - Managers must annually obtain fiduciary approval from each client before using their assets to pay that research cost.
- It's always okay for managers to use their own money to purchase research. *But*, most managers can't afford to simply pay for their current research needs (studies estimate this could eat up as much as 40% of the typical managers' profit margin).
- Managers who do not want to request such asset transfers, may instead request a Mgmt. Fee increase.
- If managers don't want to request a fee increase, they may try to minimize their out-of-pocket costs, by only paying for clients subject to MiFID II (i.e. European clients), *but continue to their US clients' money*.



New Annual Fiduciary Duties and Responsibilities

- Managers must *annually* obtain fiduciary approval from their clients before using Plan assets to buy research.
 - Each client must be formally provided with: the list of research services which the manager intends to purchase in the upcoming year, the total cost of that research for the manager, and the client's pro-rata portion of that cost (i.e. which the manager is requesting to be transferred to the manager's Research Account).
 - Each client, as the plan fiduciary, is thereby put on notice that the manager will take such amount from their Plan's assets, *unless prohibited by the client*.
 - If not prohibited by the client, that amount will be transferred (either in lump-sum payments, or ear-marked commissions), from the client's assets into the manager's Research Account.
 - Once you approve a manager's research request, that money becomes the assets of your manager!
- Beware of "*regulatory arbitrage!*" MiFID II prohibits using client assets to subsidize the research cost of other clients. Asset owners should require attestations from their managers that they won't use the commissions of US clients (that may not be subject to MiFID II) to pay the research costs of European clients (who are subject to MiFID II).
- Also be on alert for managers paying (with the manager's own money) the research costs of European clients and/or clients who object to paying for research from their Plans' assets, but not paying your Plan's research costs. This requires direct questioning of each manager.



New Investment-related risks to monitor

- Investment Banks currently produce about 90% of the research consumed by asset managers.
- In response to the new regulations, Investment Banks are projected to reduce their research production by almost 60% (from their highs in 2008).
- Consequently, managers who historically obtained research from only a couple of providers are at risk! From a due-diligence and risk-management perspective, consultants and Plan Investment Officers should know whether their managers have diverse sources for research.
- Aside from “research provider-risk,” managers who decide to pay for research out of their P&L, assume a new (and very large) expense line-item. This introduces a risk that the managers’ internal Finance Officers will argue for lower research spending (in an effort to maximize profit margins and shareholder value).
- From a due-diligence and risk-management perspective, consultants and Plan Investment Officers should know whether these managers have reduced research spending to levels that put the managers’ agreed upon investment strategy/approach at risk.



What are we seeing so far (in early 2017)?

No surprise, most managers are not yet compliant...

Manager	Investment Mandate	Overall Assessment of Research-budgeting Process				Compliance/Fiduciary Oversight Issues							Additional Best Practices	
		Overall Research Process	Uses Fund assets for research	Will be MiFID II Compliant	Applies MiFID II standards to US clients	Client Cross-subsidizing	Broker Vote vs. Ex-ante Res. Budget	Unspent research balances	Unbundle Comm.	Manager pays for other clients	Buys FX or FI research	Buys Non-research services	Research Provider List	Tracks Research Use
Manager A	US REIT	1 st Quartile	Yes	No	No	○	●	●	○	○	○	○	○	●
Manager B	Global Equity	4 th Quartile	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C	Large Cap Value	3 rd Quartile	Yes	Partially	Yes	●	●	●	○	○	○	●	○	○
Manager D	Small Cap Value	2 nd Quartile	Yes	No	No	●	○	●	●	○	○	○	○	○
Manager E	Small Cap Growth	3 rd Quartile	Yes	No	No	●	●	●	●	○	○	○	○	○
Manager F	EAFE	3 rd Quartile	Yes	Yes	Yes	N/A	○	N/A	●	●	○	○	●	○
Manager G	Large Cap Growth	3 rd Quartile	Yes	Partially	Partially	●	●	●	●	○	○	●	○	○
Manager H	Total Return	4 th Quartile	Yes	Yes	N/A	●	●	●	●	N/A	●	○	N/A	N/A
Manager I	Non-US All Country	2 nd Quartile	Yes	Yes	Yes	○	○	●	○	N/A	○	○	○	●

○ Acceptable Performance
 ● Recommend Follow-up
 N/A Manager was unable/unwilling to provide data

Initial findings (based on 60+ managers reviewed in 1st half of 2017 on behalf of Zeno clients):

- Almost 90% of the managers reviewed used client money to purchase their research.
- About 60% of the managers ran Non-MiFID II (e.g. US Large Cap Growth) strategies, of which more than half nevertheless indicated they intended to follow MiFID II's standards *and apply those standards to their US clients*.
- Of the 40% of the managers that ran MiFID II strategies, over 90% indicated they would apply MiFID II's standards to all of their clients (even if the US clients were not technically subject to MiFID II).
- A third of the managers provided inadequate levels of transparency (either because they were unwilling to disclose their policies, or their internal systems did not currently capture the data).
- Of the 49 managers who provided adequate levels of transparency, only 7 were willing to attest that they would not use funds from Zeno's clients to subsidize the research costs of their other clients.



Manager Decisions on MiFID II: Most recently...

In September, the *Financial Times* surveyed 34 managers:

- About ¼ had decided pass the research costs on to their clients (i.e. through research-budget requests).
- About ⅓ had had decided to pay for their European clients' research costs from the managers' P&L.
- The rest had not yet made up their minds.

This presents three critical questions for plan sponsors:

1. For managers that plan to continue using client assets (most likely via commissions), plan fiduciaries should be prepared to either approve or prohibit those managers' research-budget requests.
2. For managers that plan to pay with their own P&L, so far most of these managers are saying they will absorb the costs only for their European clients, not their US clients! To the extent, your Plan has "*Most Favored Nation*" clauses, Plan fiduciaries should ask those managers to justify covering the research costs of their European clients, while making your Plan pay for the research out of Plan assets.
3. For managers that are "*Undecided*," plan sponsors have a unique window of opportunity to influence these managers, so that they choose an approach in the best interests of your Plan. As with everything else, letting your managers know they are being watched is never a bad thing...



Bottom-line: Know Your Risks...

Depending how your managers pay for research, your Plan has different risks and oversight responsibilities.

➤ **Soft-Dollars**

- Were your managers' Soft-dollar commission rates reasonable?
- Were your managers' Soft-dollar purchases compliant with Section 28 (e)?
- Did your managers receive Best Execution on their Soft-dollar trades?
- Did your managers charge their European clients 'Execution-only' commission rates (but not your Plan)?

➤ **Manager who pay from research from their P&L Budget**

- Are your managers treating your Plan the same as their European clients ("*Most Favored Nation*" clauses)?
- Is your Plan subsidizing your managers' European clients research costs (to offset the managers' P&L costs)?
- Are your managers inordinately reducing the amount of research they buy (to minimize their internal P&L expenses), and how will that impact the portfolios' performance going forward?

➤ **Managers who use client money to buy research via Research Payment Accounts (RPA)**

- Prepare for your managers requesting formal approval to transfer a specific \$ amount for their 2018 research budgets.
- Approving or prohibiting these research-budget requests is a new fiduciary duty. Approval of such requests means those amounts will no longer be assets of your Fund.
- How are your managers handling those clients who prohibit the use of their assets to fund their research-budgets?



As a practical matter, what should Plan Sponsors do?

Plan Sponsors and/or their Consultants should take active steps to safeguard Plan assets. The following oversight actions should be implemented as standard due-diligence:

- **Step 1: Conduct Quantitative Analysis** of your managers' current research expenditures – to understand their policies and practices as we approach MiFID II. This also maximizes the likelihood your managers will adopt policies in your Plan's best interests.
- **Step 2: Conduct Qualitative Review** of your managers' current soft-dollar policies, and procedures - to ensure your Plan is treated fairly and doesn't subsidize the research costs of other clients; and if necessary, make informed and prudent decisions re: approving or prohibiting the use of Plan commissions for manager research-budgets.
- **Step 3 : Periodically Conduct Quantitative and Qualitative reviews** of your managers - to ensure continued compliance with MiFID II and 28 (e) regulations, and minimize the risk that your Plan will pay unnecessary costs in the future.



Sacramento County Employee Retirement System
2017 Soft-dollar & Research Budget Review



High-level Description of Findings

- Letters of Instruction were sent out to managers: Late-October, 2017
- All managers had responded by: Late-November, 2017 (final response received November 27)
- 16 Equity Strategies, and 5 Fixed Income strategies reviewed.
- In aggregate, 60+ items were identified that warranted follow-up by Fund staff and Zeno.
- The 60+ issues can be subdivided into six categories:
 - Three cost and/or return-related issues
 - Three compliance-related issues
- The Plan's staff and Zeno are in the process of following up with each manager, so as to ensure the Plan's assets are being used appropriately.



Aggregate Fund Findings

- 11 of the 21 managers reviewed used Fund assets to purchase research.
- The total amount of Plan assets used by those managers to purchase research was approx. \$230,000. This was approx. 30% of the total commissions paid by those managers.
- This is less than the typical Plan reviewed by Zeno pays, which is in part, due to the Plan's Commission Recapture program.
- Of the managers who used Plan assets to buy research, the Plan represented about 4% of those manager's aggregate AUM, and the amount of Plan assets used by those managers to buy their research was about 3% of the total research bought by those managers.
- Eight of the 16 equity managers provided "Adequate" (or better) levels of transparency regarding their research-budget policies. Of these managers, none spent a disproportionate amount of Plan assets on research.



Key Manager Findings

Cost/Return-related Findings

- 4 managers acknowledged that in order to comply with MiFID II, they would pay their European clients, but not SCERS' research costs. This may violate SCERS' "*Most Favored Nation*" clauses, and general fiduciary standards.
- 8 managers acknowledged that they currently use SCERS' Plan assets to subsidize the research costs of the managers' other clients.
- 12 managers indicated they would not be using client assets to purchase research, but rather pay for research from the managers' P&L.
 - Potential cost savings to SCERS from managers who previously used soft-dollars to purchase research.

Compliance-related Findings

- 12 managers provided inadequate levels of disclosure. For managers subject to MiFID II, this will likely not be permissible after 1/3/18, but even for US-based managers, it is inconsistent with general transparency "Best Practices" and SCERS' expected standards.
- 3 managers indicated they intended to be MiFID II compliant, but were currently engaging in practices that violated MiFID II (including not tracking whether they used the research they purchased).
- 5 US-based managers indicated they did not intend to follow MiFID II's research-purchasing rules.



Due-diligence Follow-up

In order to safeguard SCERS' Plan assets and ensure all managers are acting in the Plan's best interests, Fund Staff and Zeno are in the process to conducting follow-up due diligence on SCERS' managers to:

- Ensure that managers are not violating their fiduciary duties, and/or SCERS' "*Most Favored Nation*" contractual obligations to the Fund.
- Encourage managers to adopt policies that ensure SCERS' assets will only be used to benefit SCERS.
- Ensure that managers who use their own money to buy research continue to purchase sufficient levels of research, so as to maintain their agreed-upon investment strategies.
- Encourage at least industry-standard levels of disclosure/transparency (necessary ensure SCERS' interests are being protected).
- Clarify inconsistencies found in manager responses, and/or ensure managers not currently in compliance are actively working to bring their policies into full compliance.



Appendix:

Manager Compliance/Fiduciary Oversight Report Card



SCERS – Aggregate of Reviewed Managers

Aggregate Fund Summary *

	Trailing 12 Months
Fund Portfolio Value (\$MM)	\$3,554
% of Investment Product AUM	4%
Annual Turnover Rate:	48%
Aggregate Commissions (\$):	\$776,922 (2 bp)
% of Commissions for Research:	29%
Asset Management Fees (\$):	\$13,937,450 (39 bp)
Aggregate Research Costs \$:	
Investment Product	\$8,401,682
Fund Account	\$229,296
% of Investment Product :	3%
Number of Research Providers	
Bulge Bracket:	81 (36%)
Non-Bulge Bracket:	394 (42%)
Independent Research Providers:	158 (20%)
Expert Networks:	2 (3%)
* Numbers shown reflect the composite values of only those managers that disclosed the requested data in their responses.	

Commentary & Observations

- The total amount of Plan assets used to purchase manager research was \$229,296.
- On average, 29% of the Plan’s commissions were used to buy research.
- 11 of the 21 strategies reviewed, used Plan assets to buy research.
- Of the 11 strategies that used Plan assets to buy research:
 - 3 indicated they were, or would be MiFID II compliant and would apply MiFID II’s standards to US clients.
 - 3 provided insufficient levels of transparency into their research-budgeting processes, thereby precluding full review.
- Of the 9 strategies that provided “Adequate,” or better, levels of transparency into their research-budgeting process:
 - 0 spent a disproportionate amount of Plan assets on research (relative to the Plan’s Portfolio Value).
 - 7 used the Plan’s assets to subsidize the research costs of other clients and/or Investment Products.
 - 5 were currently establishing research budgets on an ex-ante basis.
 - 0 were currently returning unspent research balances.
 - 6 were not currently unbundling the research and execution portions of their commissions .
 - None disclosed that they cover the research costs of other clients (from the manager’s own P&L).
 - 0 indicated they used your Plan’s assets to buy non-research related services.1 was receiving research from a concentrated group of research providers.
 - 5 did not track whether they used the research they bought.



• SCERS – Aggregate of Reviewed Managers

• **Manager Compliance/Fiduciary Oversight Report Card**

Manager	Investment Mandate	Overall Assessment of Research-budgeting Process					Compliance/Fiduciary Oversight Issues						Additional Best Practices	
		Overall Research Process	Level of Disclosure Transparency	Uses Fund assets for research	Will be MiFID II Compliant	Applies MiFID II standards to US clients	Client Cross-subsidize	Broker Vote vs. Ex-ante Res. Budget	Unspent research balances	Unbundle Comm.	Manager pays for other clients	Buys Non-research services	Research Provider List	Tracks Research Use
Baillie Gifford	Emg. Mkts All Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Brandywine	Global Fixed Income	3 rd Quartile	Adequate	No	Partially	No	●	N/A	N/A	N/A	N/A	N/A	●	●
Brigade Capital	Opportunistic Credit	3 rd Quartile	Limited	No	Yes	Partially	●	N/A	N/A	N/A	N/A	N/A	●	●
Brown Advisory	US Large Cap Growth	2 nd Quartile	Adequate	Yes	Partially	No	●	●	●	○	●	○	●	○
DGHM & Co LLC	US Small Cap Value	2 nd Quartile	Superior	Yes	No	No	●	●	●	○	●	○	○	●
Eagle Captial Mgmt	US Large Cap Core	2 nd Quartile	Superior	Yes	Partially	No	○	●	●	●	●	○	○	●
Huber Capital Mgmt	US Large Cap Value	2 nd Quartile	Adequate	Yes	No	No	●	●	●	●	●	○	○	○
JP Morgan Inv. Mgmt	US Large Cap 130/30	4 th Quartile	Deficient	Yes	No	No	●	●	●	○	●	○	●	○
Lazard Asst Mgmt.	Non US All Country	2 nd Quartile	Robust	Yes	Partially	No	●	○	●	●	●	○	○	○
LSV Asset Mgmt.	Non US All Country	3 rd Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
M.A Weatherbie Capital	US Small Cap Growth	2 nd Quartile	Superior	Yes	No	No	●	●	●	●	●	○	○	●

○ Acceptable Performance
 ● Recommend Follow-up
 N/A Manager was unable/unwilling to provide data



• SCERS – Aggregate of Reviewed Managers

• **Manager Compliance/Fiduciary Oversight Report Card**

Manager	Investment Mandate	Overall Assessment of Research-budgeting Process					Compliance/Fiduciary Oversight Issues						Additional Best Practices	
		Overall Research Process	Level of Disclosure Transparency	Uses Fund assets for research	Will be MiFID II Compliant	Applies MiFID II standards to US clients	Client Cross-subsidize	Broker Vote vs. Ex-ante Res. Budget	Unspent research balances	Unbundle Comm.	Manager pays for other clients	Buys Non-research services	Research Provider List	Tracks Research Use
Mondrian Inv. Part.	Emg. Mkts All Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Mondrian Inv. Part.	Emg. Mkts. Small Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Mondrian Inv. Part.	Intl Dev. Small Cap	4 th Quartile	Limited	No	N/D	N/D	○	N/D	○	○	○	N/D	●	N/D
Neuberger Berman	US Aggregate Bond	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
Prudential Glob. Inv. Mgmt.	US- Core Plus	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
TCW	US- Core Plus	3 rd Quartile	Limited	No	N/D	N/D	●	N/A	N/A	N/A	N/A	N/A	●	N/D
UBS	US Small Cap Growth	3 rd Quartile	Deficient	Yes	Yes	Partially	○	○	●	○	N/D	○	●	●
Walter Scott & Part. LTD	Non US All Country Growth	4 th Quartile	Limited	Yes	Yes	Yes	●	●	●	●	●	○	○	○
Wedge Cap. Mgmt. LLP	US Small Cap Value	2 nd Quartile	Robust	Yes	Yes	No	●	○	●	●	●	○	○	○
William Blair & Co.	Non-US All Country	2 nd Quartile	Adequate	Yes	No	Partially	○	○	●	●	N/D	○	●	●

○ Acceptable Performance
 ● Recommend Follow-up
 ●/N/A Manager was unable/unwilling to provide data



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