International Swaps and Derivatives Association (ISDA)
International Capital Market Association (ICMA)
Asociación de Mercados Financieros (AMF)
Association of Private Client Investment Managers and Stockbrokers (APCIMS)
Association of Foreign Banks (AFB)
Bundesverband der Wertpapierfirmen an den Deutschen Börsen e.V. (BWF)
Danish Securities Dealers Association (DSDA)
Euribor ACI European Commission Working Group
Finnish Association of Securities Dealers (FASD)
Futures and Options Association (FOA)
Icelandic Financial Services Association (IFSA)
Norwegian Securities Dealers Association (NSDA)
London Investment Banking Association (LIBA)
Securities Industry and Financial Markets Association (SIFMA)
Swedish Securities Dealers Association (SSDA)

9.2.2007

Response to CESR's consultation on Inducements under MIFID (06-687)

The Associations welcome the opportunity to comment on CESR's Public Consultation on Inducements under MIFID (December 2006, CESR/O6-687).

Key comments

1. It is important for CESR to ensure that its work at Level 3 promotes consistent supervisory practices, and does not seek to interpret the Directive. We are concerned that the consultation paper goes too far into interpretative questions.

2. Furthermore, we think that CESR interprets the exemptions from MIFID's restrictions on inducements in too limited a way, and as a result would apply those restrictions to too broad a range of payments.

3. Against the background of Recital 39 and 40 of the MIFID Level 2 Directive and the provisions of the MIFID we would encourage CESR to focus more on the question whether any payments potentially falling under Art. 26 would give rise to a conflict of interest.

4. A wide range of commercial payments and commission sharing arrangements, which are not intended to induce firms to act in a way which is inconsistent with clients' interests, should not be subject to Article 26 restrictions at all.

5. We are also concerned that some of the suggested views would restrict legitimate payments to product distributors, even where such payments are properly disclosed and any conflicts of interests are appropriately managed.

6. CESR should not start any work on softing and bundling before the effects of Article 26 has become clear.

Summary

We are grateful for the opportunity to comment on CESR's consultation. We consider that the interpretive positions set out by CESR in this consultation paper will lead to very significant difficulties and that it would have been preferable for CESR to have adopted the same set of axioms as it did in its consultation paper on the Passport under MIFID (06-669), where CESR makes clear that its role at Level 3 is to promote consistent supervisory practices, but not to seek to interpret the Directive. We think that there is much sensible argumentation in the Inducements consultation paper, but we do not understand the reasoning according to which CESR has reached the interpretative conclusions that it has. We think that this argumentation points towards different conclusions, about how CESR members should consistently apply MIFID Level 2 Article 26 restrictions, *where they arise*. But the range of circumstances where the restrictions should not apply is much broader than CESR envisages.

We are seriously concerned that CESR's consultation paper interprets MIFID's provisions on inducements in a manner which seeks to apply them to a far wider range of payments and benefits than is intended under the Directive and that the interpretation will be difficult to sustain. CESR's analysis simply assumes that a wide range of payments are covered by Article 26, whereas the way in which Recital 40 and Article 26(a) and 26(c) interact makes clear that they are not:

a) Article 26(a) excludes from Article 26 all payments by or to a client or a third party acting on the client's behalf.
b) Article 26(c) excludes from Article 26 all proper fees for contributions to the service provided to the client. Moreover, the language of Article 26(c), which refers to payments which 'cannot, by their nature, give rise to conflicts', demonstrates that the principle of conflict is implicit in the concept of an inducement.
c) Recital 40 interprets what remains – Article 26(b) as applying only to inducements, i.e. payments by or to third parties whose purpose is to induce the recipient to act differently from how they would otherwise have done, and contrary to the best interests of the client.

CESR's interpretation goes too far in complicating what should be a simple distinction between payments which are inducements and payments which are not. Indeed, we think that much of CESR's detailed argumentation actually supports entirely different conclusions from the conclusions to which this consultation paper has come. It appears to us to be inescapable that the detailed arguments must, when taken as a whole, drive towards a much narrower application of Article 26 restrictions which is consistent with the detailed wording and intention of MIFID. Further, we think that CESR's Level 3 work should not seek to interpret MIFID provisions in this way, but instead deal with practical approaches to coordinating supervision. A heavily interpretative approach at Level 3 would place CESR at risk of moving beyond the remit of its responsibilities and thereby undermining its important role in coordinating the practical application of MIFID provisions. It is clear from the Level 2 Directive when inducements are prohibited and when they are not. CESR's proposed interpretation is therefore not necessary to enable firms and competent authorities to

understand what MIFID provisions require. Furthermore, CESR's proposed interpretation would not provide further clarification, but instead runs the risk of complicating the issue.

General explanation and relationship with conflicts of interest

Paragraph 1. We agree with CESR's analysis of Article 21 of the MIFID Level 2 Directive, and its conclusion that an inducement received by a firm can create a potential conflict of interest. Indeed we would go further and argue that for a payment to be an inducement, it must be an attempt to get someone to act in a way that they would not otherwise have done, which where it materially affects a client to whom a firm owes a duty under MIFID Level 2 Directive Recital 24, will necessarily give rise to a potential conflict of interest.

Paragraph 2. It would be difficult for CESR to convincingly maintain a position that Article 26 of the MIFID Level 2 Directive, read in its entirety, 'operates differently' from Article 21. Article 26 does not impose conditions on all fees, commissions, and non-monetary benefits paid to or provided by a firm, nor does it impose conditions on 'standard commissions or fees'. Article 26(a) and 26(c) exclude a broad range of payments which are not inducements, and Recital 40 of the MIFID Level 2 Directive makes clear that Article 26 imposes conditions only on 'certain inducements' and not, as CESR argues, on 'all fees, commission, and non-monetary benefits'. Given that, as we argue under paragraph 1 above, an inducement must involve a potential conflict of interest for it to be an inducement in the first place, it is clear that Article 26 must be read, contrary to CESR's assertion, in the context of Article 21.

Paragraph 6. CESR suggests that Article 26(c) has a narrow application. However a, wider interpretation would have more beneficial practical consequences and is more legally defensible. As CESR goes on to argue in this paragraph, it is only where the possibility of the receipt of a fee can act as an incentive for a firm to act other than in the best interests of its client that it should be treated as an inducement and fall under Article 26 at all. We are not clear what CESR means when it asserts that 'any items that are not of a type similar to the costs [Article 26(c) mentions]…are unlikely to fall within this exception', but it is important to be clear that Article 26(c) can apply to any incurred cost. Many fees are a straightforward remuneration for services performed, without any element which is intended to induce the recipient to do anything other than provide the service that is paid for. 'Proper fees' should be interpreted broadly as including any payment which represents a commercial payment to or by a third party for services or a contribution to services provided. CESR's approach risks converting Article 26 from a provision which is intended to regulate inducements into a provision which regulated almost any third party payment or receipt. This is definitely not what MIFID intends.

It is important to distinguish a situation where an inducement is being provided to induce someone to act in a different way from how they would otherwise have done, from where a firm is properly remunerating a third party for their part in providing service, or is being properly remunerated by someone else.

Paragraph 9. CESR's argumentation supports our analysis under paragraph 6 above. CESR states that "It is only if what the investment firm does is successful in ensuring

that the payment or receipt does not impair compliance with the investment firm's duty to act in the best interests of the client… that the payment or receipt will not be prohibited under Article 26." It therefore follows that any payment or receipt which does not give rise to a conflict of interest in the first place cannot fall under the restrictions of Article 26.

Question 1. Do you agree with CESR that Article 26 applies to all and any fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client?

No. We do not think that CESR's analysis is consistent with MIFID provisions. The effect of Articles 26(a), 26(c), and Recital 40 is to limit Article 26 only to fees, commissions, and non-monetary benefits that are inducements, i.e. third party payments whose purpose is to induce someone to act in a way that they would not otherwise have done and which would materially affect a client to whom a firm owes a duty. See our comments on paragraphs 1 to 10 above.

Question 2. Do you agree with CESR's analysis of the general operation of Article 26 of the MIFID Level 2 Implementing Directive and of its interaction with Article 21?

No. CESR's conclusions go further than can be established under MIFID, although some of CESR's analysis supports the preferable interpretation, as described above, that Article 26 has a narrow application which is consistent with the range of application of Article 21. For example, paragraph 35: "CESR considers that the arrangements that need to be considered and, where relevant, disclosed…are those that can influence or induce the investment firm…which has the direct relationship with the client" sets out an approach which should underlie the whole of CESR's analysis.

<u>Article 26(a): items "provided to or by the client"</u>

Paragraph 15. CESR states that 'circumstances in which a product provider pays a share of commission to an investment firm will…always, or almost always, be dealt with under Article 26(b)'. We are very firmly of a different view: that it is clear from the text that Article 26(a) should apply to a wide range of arrangements where a firm is properly remunerating a third party for their part in providing the service to the client, or is being properly remunerated by someone else in relation to that service.

Question 3. Do you agree with CESR's view of the circumstances in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by…a person acting on behalf of the client"?

CESR should not seek to limit Article 26(a) to circumstances where the third party acts on an explicit instruction by the client. The drafting of the MIFID provisions supports a much wider interpretation. It should be interpreted as covering any circumstances in which the payer or receiver acts on the client's behalf, including for example commission sharing arrangements that represent remuneration for the recipient's contribution to the service, and do not induce the recipient to act in a way that would materially affect the client's interests, particularly where the commission

sharing agreement is disclosed to the client. To further support this comment, if any commission payments have been properly disclosed to the client and, thus, the client is fully aware of such payments in requesting any corresponding services the client implicitly accepts and consents to such payments (since the commission arrangement would also be part of the requested services).

Question 4. What, if any, other circumstances do you consider there are in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by the client or a person acting on behalf of the client"?

There will be a wide range of circumstances in addition to those that CESR identifies where an item should be treated as a fee, commission, or non monetary benefit provided to our paid by the client or a person acting on behalf of the client. It is not possible to identify them all definitively, but they will include, for example, normal commercial commission sharing arrangements, because they constitute compensation for part of the services provided to the client.

<u>Article 26(b): conditions on third party receipts and payments</u>

Paragraphs 16ff. In this section, CESR applies argumentation to the question of whether or not a fee, commission, or benefit is designed to enhance the quality of the service, and does not impair compliance with the duty to act in the best interests of the client, which it should instead apply to the question of whether or not a fee, commission, or benefit is an inducement to which Article 26 applies at all.

Paragraph 19. CESR should not go so far as to state that there must *be* benefit to the client in relation to a particular service. The Article 26(b)(ii) test is that the payment or benefit must be *designed* to enhance the quality of the relevant service. 'Relevant service' and 'client' therefore need to be interpreted more broadly, in an intentional rather than specific sense, and so that it applies to steps taken to create an environment where there is a general tendency to increase the quality of the service, and no requirement to demonstrate that the inducement has actually enhanced the service in any particular case. This limitation leads to an excessively restrictive effect which would be further compounded by the use of a restrictive interpretation of the exemptions in Article 26(a) and 26(c), resulting in a far greater restriction on third party payments than was intended under MIFID.

Paragraph 21. We agree with CESR that in many cases it is difficult to consider the payment or receipt of a fee, commission, or other benefit in isolation from other factors such as the conditions that attach to it. It is precisely these other factors which should determine whether a conflict of interest arises which means that the payment is an inducement to which Article 26 restrictions should apply at all: see our comments on paragraphs 1 to 10 above.

Paragraph 22. We do not agree that A26 imposes a proportionate principle to be applied in testing if a specific payment should be regarded as a prohibited inducement. In light of Recital 39 and 40, rather than to focus on the correlation between a payment and the quality of a service CESR should focus its guidelines on the conflicts issue. Such guidelines should clarify that the receipt by an investment firm of a commission in connection with investment advice or general

recommendations, in circumstances where the advice or general recommendations are not biased, should be considered as designed to enhance the quality of the investment advice to the client. The application of Article 26(b)(ii) should be concerned with the judgement of whether or not the inducement does in fact impair compliance with the duty to act in the best interests of the client.

We would also encourage CESR to provide clarity that Recital 39 also applies to portfolio management services given that the same considerations apply here and given that typically advisory services are very closely connected to such services.

Paragraph 23. As under paragraph 22 above, the question of whether a payment or receipt is designed to induce the firm to act contrary to the best interests of the client should determine whether payment or receipt is an inducement to which Article 26 restrictions should apply or not, before there is a need to consider whether or not it is designed to enhance the quality of the relevant service.

Paragraph 25. As a general observation, we question how helpful examples of this nature are for a document of this sort, since they can never be exhaustive. A situation, even when meeting the basic fact patterns provided in an example, may especially in this area driven by conflict of interest considerations warrant a different assessment based on additional facts. Also, firms and regulators will need to apply the inducement provisions to a range of different circumstances which do not correspond to the examples. CESR should therefore focus on general indicative factors, as set out elsewhere in this response.

Also, the examples take insufficiently into account Recital 39 and 40 and its stress on assessing whether a service has been biased in reaction to an inducement.

We have the following specific comments on CESR's examples:

Example 1. Such commission-sharing arrangements should not fall under Article 26 restrictions at all unless they give rise to a conflict of interest. Where this is not the case, the commission share represents remuneration for a contribution towards the service, which regulation should not seek to influence.

We are concerned that some of the explanation given in the example could distract from the framework which Art. 26 and Recital 39 set for analysing distribution arrangements. It is important that the inducements provisions are not interpreted in a way that restricts the appropriate remuneration of product distributors. Recital 39 makes clear that this apply to where the recipient provides investment advice.

In interpreting this provision, regulation should not aim to question whether a commission is "disproportionate to the value of the service provided". Recital 39 suggests that the key question should rather be, for services which include advice, whether the advice is biased. The same will apply to portfolio management services.

Example 2. In this example concerning the reception and transmission of orders such commission arrangements should not fall under Article 26 restrictions at all unless they give rise to a conflict of interest. Where this is not the case, the

commission represents remuneration for a contribution towards the service, which regulation should not seek to influence.

These considerations should apply in the same way whether the distribution concerns a UCITS or, for example, a structured derivative product as the affected customer interests and potential conflicts are the same.

Example 3. We agree that the arrangement that CESR describes appears to be an inducement. Whether or not it satisfied the requirement that it be designed to enhance the quality of the service would need to be determined on the facts of the case, although it should not be assumed that it does not: for example, if the service could not otherwise be provided, the ability to provide the service to the client at all may constitute an enhancement of its quality, or a proper fee which enables the provision of the service.

Example 4. In such circumstances, the key question is whether or not there is an inducement. It would be necessary to examine the specific circumstances: in many cases the provision of training would not be an inducement because it would not induce, or be designed to induce, the firm to behave differently. If it were an inducement, it would again be necessary to judge on the facts of the case whether or not it was designed to enhance the service.

Example 5. Such commission sharing arrangements should not fall under Article 26 restrictions at all unless they give rise to a conflict of interest. They represent the remuneration which the firm pays to the introducer for the service of introducing the client to the firm. As such they constitute a proper fee which enables the provision of the service.

Example 6. We agree that the arrangement CESR describes appears to be an inducement. Whether it may be designed to enhance the quality of the services will depend on the facts. We agree that arrangements which would likely lead to biased advice would not meet this test, but appropriate distribution payment structures which take into account efficiencies realised by larger distributors would not necessarily lead to such bias.

Example 7. Such a scenario might be an inducement, if for example the provision of computers was disproportionate. But if they were of no material value, and it was market practice to do so, it might not be.

Example 8. We think the analysis of this example does not take sufficient account of Recital 39, which acknowledges for advice that the receipt of payments can enhance the quality of the service, provided that the resulting advice or recommendations are not biased. The same should also apply for portfolio management services. Arrangements that involve payment of distribution fees by product providers are widely acknowledged in the market. Provided they are appropriately disclosed and the portfolio management is not biased, they can lead to the availability to clients of a wider product spectrum, reduced on-going portfolio management fees and an overall enhancement of the portfolio management service.

Paragraph 26. See our comments on paragraphs 16ff at the beginning of this section. In many cases, the examples deal with factors in establishing whether there is an inducement in the first place, not whether a payment is designed to enhance the quality of the service.

Question 5. Do you have any comments on the CESR analysis of the conditions on third party receipts and payments?

See our comments on paragraphs 16 to 26 above.

Question 6. Do you have any comments on the factors that CESR considers relevant to the question whether or not an item will be treated as designed to enhance the quality of a service to the client and not impair the duty to act in the best interests of the client? Do you have any suggestions for further factors?

See our comments on paragraphs 16 to 26 above.

We stress the importance of a broad interpretation of the requirement that an inducement must be designed to enhance the quality of the service to the client, so that, for example, the fact that the inducement enables the service to be provided at all is taken to represent an enhancement of its quality.

Article 26(b): disclosure

Paragraph 30. CESR should not add extra interpretation over and above what is in the MIFID provisions. The requirement that the disclosure is clear, comprehensive, accurate, and understandable is all that is needed. How this requirement applies appropriately in any particular circumstances will vary from case to case, but there should be no new criteria.

Paragraph 31. We agree with CESR that it would not be appropriate to provide guidance on the detailed content of summary disclosure.

Paragraph 32. We agree that Article 26(b) disclosure should relate only to receipts or payments by the firm that is providing the service to the client.

Question 7. Do you agree that it would not be useful for CESR to seek to develop guidance on the detailed content of the summary disclosures beyond stating that: such summary disclosure must provide sufficient and adequate information to enable the investor to make an informed decision whether to proceed with the investment or ancillary service; and that a generic disclosure which refers merely to the possibility that the firm might receive inducements will not be considered as enough?

We strongly agree that it would not be useful for CESR to seek to develop guidance on the content of summary disclosures.

Question 8. Do you agree with CESR's approach that when a number of entities are involved in the distribution channel, Article 26 applies in relation to fees, commissions and non-monetary benefits that can influence or induce the intermediary that has the direct relationship with the client?

We agree, where Article 26 restrictions do apply (see our comments above), that they should do so only to those fees, commissions, or non-monetary benefits that can influence or induce the intermediary that has the direct relationship with the client.

Tied agents

Question 9. Do you have any comments on CESR's analysis of how payments between an investment firm and a tied agent should be taken into account under Article 26 of the Level 2 Directive?

Question 10. Are there any other issues in relation to Article 26 and tied agents that it would be helpful for CESR to consider?

We do not have any comments on this section.

Softing and bundling arrangements

Paragraph 44. CESR states that it intends to carry out a programme of work to understand whether it is necessary to have a common approach across the EU to softing and bundling arrangements, and if so, develop such an approach. We do not think that CESR should do so at this stage, but that instead it should rely on a market-led approach to any coordination of arrangements, for the following reasons:

While more uniformity may be desirable, regulation of softing and bundling at present reflects the particularities of specific markets and investors in those markets. Any move towards a uniform common approach would need to avoid disruption to existing arrangements that have already involved recent and significant change to which the market has only recently adapted;

A market-led approach is already well under way in the UK and France as well as other major international markets such as the US. CESR should not disturb this process;

Before any move towards coordination is made, it would be necessary to understand how existing softing and bundling rules interact with Article 26 requirements in practice.

Question 11. What will be the impact of Article 26 of the MIFID Level 2 Directive on current softing and bundling arrangements?

Although existing requirements in, for example the UK are likely to be broadly similar to a correct application of Article 26, it will be necessary to examine how Article 26 operates in practice to be able to answer this question.

Question 12. Would it be helpful for there to be a common supervisory approach across the EU to softing and bundling arrangements?

See our comments on paragraph 44 above. While a consistent approach may be helpful, it would need to be market-led, and take account of existing arrangements and how they interact with MIFID provisions in practice.

Question 13. Would it be helpful for CESR to develop that common approach?

No. Any work should be market-led.