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CONSULTATION PAPER

**Inducements:
Good and poor practices**

Deadline for contributions: CESR invites responses to this consultation paper by **22 December 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests its submission to be confidential.



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I Executive Summary

As part of ensuring an investment firm acts in compliance with the principle stated Article 19(1) of the Markets in Financial Instruments Directive 2004/39/EC ("MiFID"), Article 26 of the MiFID implementing Directive 2006/73/EC ("Level 2 Directive"), titled "Inducements", sets out requirements for the receipt or provision by an investment firm of a fee, commission or non-monetary benefit.

The purpose of this consultation is to highlight some of the observed industry practices (based on a questionnaire CESR members distributed to investment firms) on the MiFID inducements rules and to provide investment firms with an understanding of how CESR views such practices. Throughout the consultation paper CESR has indicated what types of firm behaviour European securities regulators encourage (good practices) and discourage (poor practices). This is expected to provide firms with a benchmark against industry compliance with the MiFID inducements rules, with the additional comfort of knowing whether European securities regulators encourage or discourage particular instances of firm behaviour.

The main points of discussion are under the following five headings:

Classifying payments and non-monetary benefits and setting up an organisation to be compliant: Overall, most investment firms understood the MiFID inducements rules and have taken measures with a view to ensuring compliance. The differences observed in the arrangements and procedures firms set up to comply with the rules, were in part due to the scale and nature of their business and the degree to which the MiFID inducements rules had impacted their business. Where firms documented their processes, the decisions on admissible payments and non-monetary benefits were based on predefined assessment principles/factors, or decisions were taken by specific functions within the firm. The role of the compliance function, with the support of senior management, was generally seen as essential in facilitating effective compliance.

Only a small number of firms (mostly investment firms providing portfolio management services) reported a change in their remuneration structure as a consequence of the rules. Some firms also considered the rules had enhanced transparency to clients of the commission structures.

Proper fees: Investment firms gave examples of payments they considered were proper fees under Article 26(c) of the Level 2 Directive. CESR provides a view on some of the payments which are proper fees. These include all fees necessary for the provision of order execution services which, by their nature, cannot give rise to conflicts with the best interests of the investment firm's clients. All kinds of fees paid by a firm in order to access and operate on a given execution venue should normally be considered as such (under the general category of settlement and exchange fees).

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting for the best interests of the client and designed to enhance the quality of the service provided to the client: Many of the firms responding to the questionnaire listed specific methods of managing potential conflicts caused by third party payments and non-monetary benefits provided or received by the firm and considered the conflicts of interest policy as a vital tool in ensuring that such payments and benefits do not cause the firm to act contrary to the client's best interests.

A variety of justifications were put forward by investment firms as to why certain payments and non-monetary benefits were designed to enhance the quality of the service to the client. However, some of the responses suggested that firms find it difficult to grasp the 'designed to' aspect and focused on whether the payment 'enhances the quality of the service to the client'. In

addition, some firms considered the 'designed to enhance' criterion as not separate from the duty to act in the best interests of the client.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure: Most investment firms disclose to clients third party payments and non-monetary benefits they provide or receive via a summary disclosure. Differences were noted in the degree to which the disclosures provided sufficient information to enable clients to make an informed investment decision. A large majority of firms noted that their clients did not request further information after receiving a summary disclosure.

Experience of firms' cross border implementation: The majority of investment firms did not have to adopt any different arrangements or procedures across the Member States concerned to comply with Article 26 of the Level 2 Directive. The small minority of firms that reported that they had to make changes were mostly internationally active groups operating several subsidiaries across Europe, and tended to develop a uniform group approach to comply with the MiFID inducements rules.

Views are specifically sought from stakeholders on the consultation questions posed in the relevant chapters. The questions are on aspects of the MiFID inducements rules which are being addressed for the first time by CESR.

II. Introduction

1. Article 19(1) of the Markets in Financial Instruments Directive 2004/39/EC ("MiFID") states that when providing investment services and/or, where appropriate, ancillary services to clients an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients. Article 26 of the MiFID implementing Directive 2006/73/EC ("Level 2 Directive"), titled "Inducements", sets further requirements for the receipt or provision by an investment firm of a fee, commission or non-monetary benefit that could, in certain circumstances, place the firm in a situation where it would not be acting in compliance with the principle stated in Article 19(1) of MiFID.
2. Under Article 26 of the Level 2 Directive, investment firms can pay/provide or be paid/provided the following types of fees, commissions or non-monetary benefits in relation to the provision of an investment or ancillary service to a client:
 - I. fees, commissions (hereunder referred to as "payments") or non-monetary benefits paid or provided to or by the client or a person on behalf of the client (Article 26(a) of the Level 2 Directive);
 - II. payments and non-monetary benefits paid or provided to or by a third party or a person on behalf of a third party, where the following conditions are satisfied (Article 26(b) of the Level 2 Directive):
 - o clear prior disclosure is ensured to the firm's client;
 - o the item is designed to enhance the quality of the relevant service to the client and it does not impair compliance with the firm's duty to act in the best interests of the client;
 - III. proper fees which are necessary for the service and cannot conflict with the firm's duty to act in the best interests of its client (Article 26(c) of the Level 2 Directive).
3. CESR published Level 3 recommendations on inducements (CESR/07-228b) in May 2007, after consulting twice on the matter (CESR/06-687 published in December 2006 and CESR/07-228 published in April 2007)¹, with the main intention of facilitating a consistent implementation and application of Article 26 of the Level 2 Directive.
4. Two years on, and in part as a response to calls from the industry and investors for CESR to pursue further work to ensure a common and consistent interpretation and application of the MiFID inducements rules, CESR members undertook an industry survey² to gather information on the current application of these rules within the EU. More than 150 regulated firms responded to the questionnaire. The sample included a representation from different sized credit institutions, investment firms and fund management companies providing portfolio management services (jointly referred to as investment firms below).
5. The main objective of this consultation is to assist regulated firms in gathering a better understanding of some of the main industry practices on inducements and to understand what types of behaviour by firms securities regulators encourage (good practices) and discourage (poor practices). This way, firms can benchmark themselves against industry compliance practices under the MiFID inducements rules, with the additional comfort of knowing whether securities regulators encourage or discourage particular instances of behavior by firms..

¹ See Annex III - Relevant CESR inducements documents.

² See Annex II - CESR Inducements questionnaire.



Status of this consultation paper

6. None of CESR's views, opinions, judgments and statements contained in this paper constitutes European Union legislation. This paper does not propose any legislative or regulatory changes.
7. CESR uses the term 'good practice' throughout this consultation paper to refer to industry practices observed, which CESR considers to be sensible actions for investment firms to follow. CESR endorses and encourages these practices, although it recognises that it is sometimes reasonable for different types of firms to follow different routes to comply with the same legal requirements. The good practices described in this paper are practices CESR considers would be an indicator of compliance with the relevant part of the MiFID inducements rules that they refer to.
8. CESR uses the term 'poor practice' throughout this document to refer to industry practices observed which CESR considers to be imprudent actions for investment firms to follow. CESR discourages these practices, which in many cases will lead a firm to be in breach of the MiFID inducements rules..
9. The final CESR inducements report will be a Lamfalussy Level 3 paper targeted at both regulators and investment firms directly which will consider specific instances of firm behaviour and industry practice and will set out a collective view from securities regulators across Europe on certain practices related to the MiFID inducements rules..

Public consultation and timetable

10. CESR invites comments from stakeholders on this consultation paper of good and poor practices on inducements. Respondents can post their comments directly on the CESR's website (www.cesr.eu) in the section "Consultations". The consultation closes on 22 December 2009.
11. The purpose of this consultation is to receive responses on the content of this consultation paper only on aspects which are dealt with for the first time, since the previous Level 3 recommendations on inducements remain fully applicable, CESR does not intend to reopen discussion on the 2007 recommendations. Therefore CESR has included specific questions to highlight those areas in which views of respondents are invited. Respondents are welcome to make other relevant points on those areas.
12. As in the May 2007 CESR Level 3 recommendations, CESR has used examples to illustrate regulators' views relevant to the topics dealt with in each section of this paper. These examples are not supposed to be comprehensive and should not be read out of the context of the particular sections in which they are included. Supervisory judgment on investment firms' practices will have to be conducted on a case by case basis.
13. This consultation paper has been prepared by the MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its Sub-Group on Intermediaries, chaired by Mrs Maria Jose Gomez Yubero, Director at the CNMV. The rapporteur for this workstream is Diego Escanero (descanero@cesr.eu).



Consultation questions:

Classifying payments and non-monetary benefits and setting up an organisation to be compliant

Question I: Do you agree with CESR's views about the arrangements and procedures an investment firm should set up?

Question II: Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?

Question III: What are your comments about CESR's view that at least the general approach the investment firm is going to undertake regarding inducements (its 'inducements policy') should be approved by senior management?

Proper fees:

Question IV: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?

Question V: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?

Question VI: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the service provided to the client:

Question VII: Do you agree with CESR's view that in case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?

Question VIII: Do you have any comments regarding CESR's view that measures such as an effective compliance function should be backed up with appropriate monitoring and controls to deal with the specific conflicts that payments and non-monetary benefits provided or received by an investment firm can give rise to?

Question IX: What are your comments on CESR's view that product distribution and order handling services (see §74) are two highly important instances where payments and non-monetary benefits received give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?

Question X: What are your comments on CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?

Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure:



Question XI: Do you have any comments on CESR's views about summary disclosures (including when they should be made)?

Question XII: What are your comments on CESR's views about detailed disclosures?

Question XIII: Do you have any comments on CESR's views on the use of bands?

Question XIV: Do you agree with CESR's views on the documentation through which disclosures are made?

Question XV: Do you agree with CESR's views on the difference of treatment between retail and professional clients?

III. Classifying payments and non-monetary benefits and setting up an organisation to be compliant

Background

14. Article 6 of the Level 2 Directive requires investment firms to establish, implement and maintain adequate arrangements and procedures to deal with their obligations under MiFID. These arrangements and procedures should be in place to help the firms to comply with Article 26 of the Level 2 Directive.
15. CESR's 2007 recommendations on inducements³ provide further clarification regarding Article 26 of the Level 2 Directive, which should be taken into account by investment firms when classifying payments and non-monetary benefits between the three categories foreseen in Article 26 of the Level 2 Directive.
16. Finally, it should be noted that investment firms are required to maintain adequate and orderly records of their business and internal organisation (Article 5(1) (f) of the Level 2 Directive). This requirement should be considered under the MiFID inducements rules as well. To this extent, CESR introduced in its minimum list of records (Ref: CESR/07-085) a record keeping requirement with regard to information to be disclosed to clients with reference to inducements, pursuant to Article 13(6) of MiFID.

Summary of findings

Classification of payments and non-monetary benefits and types of arrangements and procedures⁴

17. Most of the investment firms sampled said that they assess payments and non-monetary benefits they provide or receive for compliance with Article 26 of the Level 2 Directive. Nevertheless, only a minority of firms documented in a detailed manner their processes for categorising and assessing such payments and benefits and only a few firms gave complete explanations of the types of arrangements and procedures they have set up to ensure that each (or each type of) payment and benefit complies with the MiFID inducements rules.
18. Where investment firms had specific arrangements and procedures in place to comply with the MiFID inducements rules, firms' procedures for identifying and classifying payments and non-monetary benefits usually considered all payments and benefits the firms provide or receive in relation to the provision of any investment or ancillary service

³ CESR/07-228b, Inducements under MiFID, see Annex III.

⁴ From section 1 of the CESR Inducements questionnaire- see Annex II.

to their clients. In this respect, most firms said they compiled inventories from the payments identified in their commercial records and/or accounting data to obtain a list of existing relevant payments. In the case of new products and services, the procedure for approving the new activity involved identifying new payment flows and non-monetary benefits for MiFID inducements rules purposes.

19. Once relevant payments and non-monetary benefits have been identified, they are classified under Article 26 of the Level 2 Directive as (a) flowing between the firm and clients; (b) flowing between firms and third parties; (c) a proper fee; or considered as not allowed.
20. Some of the investment firms sampled did not provide information on how the payments and non-monetary benefits fulfilled the criteria of enhancement and/or the fulfillment of the firm's duty to act in the best interests of the client. Where firms did provide information on their assessment of whether the payments and benefits were admissible, CESR observed that in some cases, the assessment was undertaken on the basis of a predefined principle and/or a list of factors to be considered to determine whether a given fee structure may be set up or maintained. Other firms left the judgment on the legitimacy of payments and benefits under Article 26(b) of the Level 2 Directive to a specific function (usually to the compliance department or to multidisciplinary teams) to exercise, which was not based on any predefined assessment principles.
21. Some investment firms also stated that their flows of payments and non-monetary benefits were reviewed on an ongoing basis and were incorporated into processes of committees in charge of validating any new product launches.
22. While the review of whether the payments and non-monetary benefits are admissible under Article 26(b) of the Level 2 Directive, is required to be performed prior to the provision of the service to which the payment refers, some investment firms suggested that they leave at least a part of the required checks (e.g. enhancement test) to compliance controls after the provision of the service.
23. For payments classified under Article 26(c) of the Level 2 Directive, CESR observed that many investment firms tended to classify payments under the proper fees category without any appropriate checks of the conditions required (i.e. the payment is necessary for the service and cannot conflict with the firm's duty to act in the best interests of its client).
24. Several of the investment firms sampled also made a narrow reference to inducements solely in their conflict policies and did not consider the wider scope of the MiFID inducements rules, which are in effect rules preventing firms from providing or accepting certain types of payments and non-monetary benefits.
25. None of the respondents referred expressly to any arrangement for the record keeping of information disclosed to clients regarding inducements.

Impacts

26. A good portion of the investment firms sampled stated that the arrangements and procedures set up for inducements had not significantly impacted their previous practices regarding payments and non-monetary benefits. However, a small number of firms (mostly investment firms providing portfolio management services) reported they had changed their remuneration structure as a consequence of the MiFID inducements rules. Some firms considered that the rules had enhanced transparency to clients of the commission structures. Other respondents performing individual portfolio management stated that they had ceased to accept rebates from product providers in relation to financial instruments purchased for client portfolios.

Information provided to senior management and relevant staff / role of the senior management

27. Most investment firms said that compliance with the MiFID inducements rules is generally covered by compliance reports to senior management, but stated that no specific inducement reports were provided to their senior management. In addition, only a few respondents submitted their “policy on inducements” to senior management for their approval.
28. Most investment firms noted that the inducements rules had been part of the general MiFID training to relevant staff. In general inducements arrangements have been incorporated into the procedures manual circulated to all the staff. Only a few firms reported that the MiFID inducements rules were subject to a specific mandatory training course electronically traced in order to ensure the active involvement of all relevant staff.

CESR's reactions regarding those findings and key issues

29. CESR believes that arrangements and procedures are essential in fulfilling investment firms’ obligations under the MiFID inducements rules. In this context, firms enjoy a certain degree of flexibility in the approach to be adopted according to the nature, scale and complexity of their business and the nature and range of investment services and activities undertaken in the course of that business.
30. The complexity of investment firms’ arrangements and procedures may differ depending on who is giving/receiving the payment or non-monetary benefit (client or third parties), whether the payment or benefit is necessary for the provision of the service to the client and whether the payment or benefit by its very nature gives rise to a potential conflict of interest with the firm’s duty to act in the best interests of its clients.
31. Indeed, if the investment firm correctly assesses that a payment or non-monetary benefit is between a firm and client (Article 26(a) of the Level 2 Directive), no more verification is required for the purposes of the MiFID inducements rules. For third party payments which enable or are necessary for the provision of investment services (such as custody costs, settlement and exchange fees, regulatory levies or legal fees), the firm’s procedures should assess whether, by its nature, the payment cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients for the payment to be classified as a proper fee (Article 26(c) of the Level 2 Directive).
32. Other third party payments and non-monetary benefits require a more detailed approach in setting up appropriate procedures, since Article 26(b) of the Level 2 Directive requires investment firms when providing or receiving third party payments and benefits to meet both of the following conditions:
 - ascertain whether the item is designed to enhance the quality of the relevant service to the client and whether it does not impair compliance with the firm’s duty to act in the best interests of the client; and
 - ensure clear disclosure to the firm’s client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service.
33. The findings as summarised above show that firms have adopted a wide range of approaches in pursuing compliance with the MiFID inducements rules.
34. Any approach investment firms use should enable the Competent Authority to verify that the firm’s relevant payments and non-monetary benefits are compliant with the MiFID

inducements rules. The procedures should (1) identify relevant payments and benefits or types of payments and benefits occurring in relation to the provision of an investment or ancillary service to the client for the purposes of the MiFID inducements rules (**identification**). Once relevant payments and benefits or types of payments and benefits have been identified, a firm should be able to (2) classify them under Article 26 of the Level 2 Directive (**classification**). For a payment or non-monetary benefit flowing between a firm and a third party (Article 26(b) of the Level 2 Directive) the firm should (3) assess how the payment or benefit fulfills the conditions for the MiFID inducements rules to be admissible (**evaluation**). Procedures should also be able to prevent any payment or benefit from taking place if it does not meet the requirements of Article 26 of the Level 2 Directive. It is good practice that the compliance function is involved in these procedures to ensure that payments and benefits the firm provides or receives adhere to the MiFID inducements rules.

35. With regard to standardised recurring payments and non-monetary benefits an investment firm may provide or receive, for example those relating to the distribution of financial instruments, such as Collective Investment Schemes (CIS), CESR considers that if the type of payment or non-monetary benefit has already been correctly assessed as fulfilling Article 26(b) or (c) of the Level 2 Directive, such payments or benefits may only need to be reviewed periodically to ensure that they continue to comply with the MiFID inducements rules. If there is a material change in the payment or benefit, including in the terms of the commercial relationship with the third party or other circumstances surrounding the payment or benefit, it must then be reassessed to ensure that it complies with the rules.
36. The procedures implemented by the investment firm should ensure that any new relationship originating payments or non-monetary benefits should be subject to an appropriate assessment of admissible payments and benefits. For example, any draft of new contracts (or proposed amendments to existing practice) such as distribution agreements providing for the relevant payments and benefits should be considered under the MiFID inducements rules and the resulting payments and benefits should only occur once all regulatory obligations are complied with.
37. Specific responsibilities and compliance controls should be set up by the investment firm to ensure compliance with the MiFID inducements rules. These should include appropriate monitoring and procedures to deal with the specific conflicts of interest related to inducements. In addition, CESR deems appropriate that at least the general approach that the investment firm is going to undertake with respect to inducements should be approved by the senior management of the firm.
38. The compliance function of the investment firm, by virtue of Article 6 of the Level 2 Directive, should also assess on an ongoing basis the adequacy and effectiveness of the measures and procedures put in place in accordance with the inducements rules. In discharging this responsibility the compliance function needs to have the support of the firm's senior management to enable it to challenge decisions made by the business as well as the skills and knowledge necessary to assist the business in ensuring that the firm's policies, in particular its conflicts policy, are adhered to. In addition, the compliance function should consider inducements in its compliance reports to senior management⁵.

Question I: Do you agree with CESR's views about the arrangements and procedures an investment firm should set up?

⁵ Article 9(2) of the Level 2 Directive requires investment firms to ensure that their senior management receives on a frequent basis, and at least annually, written compliance reports indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.



Question II: Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?

Question III: What are your comments about CESR's views that at least the general approach the investment firm is going to undertake regarding inducements (its 'inducements policy') should be approved by senior management?

Good and poor practices - setting up of specific arrangements devoted to the MiFID inducements rules

Poor Practices

Example 1: An investment firm relies exclusively on its conflict of interest policy in order to comply with the MiFID inducements rules without setting up any arrangements specifically devoted to checking all the conditions under Article 26 of the Level 2 Directive.

Comments

Effective internal procedures should enable firms to monitor and evaluate payments and non-monetary benefits under the MiFID inducements rules. The MiFID inducements rules are in addition to and in some respects wider than MiFID rules on conflicts of interest; therefore it is non compliant for investment firms to solely rely on their general conflict of interest policies for the purposes of the MiFID inducements rules. The MiFID conflicts of interest rules and the MiFID inducements rules in the legal framework in force are complementary and not substitutes or alternatives. In its 2007 recommendations⁶ CESR specifically stated that: "Compliance with the conflicts rules does not provide a safe harbour from the inducements rules. Compliance with the inducements rules does not provide a safe harbour from the conflicts rules." For example, Article 26 of the Level 2 Directive should not be treated as applying only to payments and non-monetary benefits made or received with the purpose or intent to influence the actions of a firm; on the other hand, it should be noted that the MiFID rules on conflicts of interest also apply to individuals working for the investment firm.

Good and poor practices - identification of payments and non-monetary benefits

Good Practices

Example 1: An investment firm sets up arrangements and procedures to identify (taking into account commercial and/or accounting records) relevant payments and non-monetary benefits for the purposes of the MiFID inducements rules. Internal procedures ensure that an assessment of each type of relevant payment or benefit is performed before any payment or benefit is provided or received (e.g. the new product committee is required to make any envisaged new payment or benefit known to the internal units responsible for inducements compliance).

Poor Practices

Example 1: An investment firm's policy considers that payments and non-monetary benefits provided to or by legal entities within the same group do not fall under the MiFID inducements rules.

⁶ See paragraph 17, CESR/07-228b, Inducements under MiFID, Annex III



Example 2: An investment firm undertakes identification and assessment of the payments and non-monetary benefits provided or received for the purposes of the MiFID inducements rules only after the provision of the relevant service to the client.

Comments

Investment firms need to review all types of fees, commissions and non-monetary benefits they provide or receive in relation to the provision of an investment or ancillary service to their clients prior to the provision of any such service. This implies that each relevant payment and benefit (or type of payment and non-monetary benefit) should be identified and classified on an ex ante basis under Article 26 of the Level 2 Directive. Internal procedures should facilitate the firm's compliance with the MiFID inducements rules. Both existing and envisaged new products and services as well as commercial relationships should be reviewed for purposes of the MiFID inducements rules..

It should be noted that the application of Article 26 of the Level 2 Directive is the same in relation to payments and non-monetary benefits within the same group as the investment firm as it is to payments and non-monetary benefits provided to or by any legal entity outside the group.

Good and poor practices - classification of payments and non-monetary benefits

Good Practices

Example 1: An investment firm sets up specific arrangements and procedures in order to map relevant payments and non-monetary benefits under the three categories provided for in Article 26(b) of the Level 2 Directive.

Poor Practices

Example 1: An investment firm's internal procedures are able to single out, from all payments and non-monetary benefits traced, only those falling under Article 26(b) of the Level 2 Directive.

Comments

Procedures need to identify all relevant payments and non-monetary benefits and classify them under one of the three categories provided for in Article 26 of the Level 2 Directive. Arrangements set up by an investment firm should be regarded as non compliant if any relevant payment or benefit is not considered by the procedures. This would be the case where, for example, arrangements provide only for the identification of payments and non-monetary benefits under Article 26(b) of the Level 2 Directive or provide only for an ex post approach by the compliance officer (when new commercial relationships or payment flows are already established).

Good and poor practices - evaluation of payments and non-monetary benefits

Good Practices

Example 1: An investment firm sets up specific arrangements and procedures which enable the proper assessment of its payments and non-monetary benefits for the purposes of Article 26 of the Level 2 Directive. The basis on which the assessment is made is explicitly incorporated in the firm's policies and procedures.

Poor Practices



Example 1: An investment firm's procedures for evaluating the legitimacy of third party payments and non-monetary benefits focus almost exclusively on the assessment of whether payments and non-monetary benefits are correctly classified. In particular, the compliance test implemented by the firm under Article 26(b) of the Level 2 Directive generally presumes that the "designed to enhance" criterion is met.

Comments

After a payment or non-monetary benefit (or type of payment or benefit) is classified, procedures should check if it meets the conditions established under Article 26 of the Level 2 Directive for that particular category of payment and non-monetary benefit. Therefore any payment or non-monetary benefit falling under Article 26(b) of the Level 2 Directive should be assessed to see if it meets the following conditions:

- *it is designed to enhance the quality of the service;*
- *it does not impair compliance with the firm's duty to act in the best interests of the client*
- *a clear, prior disclosure is given to clients.*

A poor practice occurs when an investment firm evaluates the legitimacy of payments and non-monetary benefits without reference to all the conditions listed above, for instance limiting the assessment only to the proper classification of payments and non-monetary benefits.

In the same manner a firm cannot consider a given payment as a proper fee without being satisfied of the fulfilment of the following conditions:

- *the payment is necessary for the service;*
- *it cannot give rise to conflicts of interest between the firm and its clients.*

Moreover, procedures can be considered as poor if the basis for the decision/evaluation process is not appropriately incorporated in the investment firm's policies and procedures to be followed when assessing the legitimacy of the payments and non-monetary benefit.

The assessment of the conditions required may be complex when a payment or non-monetary benefit falls under Article 26(b) of the Level 2 Directive. To assist investment firms, CESR's recommendations on inducements⁷ suggested factors to be considered when determining whether an arrangement may be deemed to have been designed to enhance the quality of the service provided to the client and does not impair the duty of the firm to act in the best interests of the client. These are:

- *the type of service provided;*
- *the expected benefits to the client and to the firm;*
- *whether there is an incentive likely to change the investment firm's proper behaviour;*
- *the relationship between the firm and the entity involved with the benefit; and*
- *the nature of the item.*

Good and poor practices - recordkeeping

Good Practices

Example 1: An investment firm sets up specific arrangements and procedures to be able to record and track every relevant action by the firm for the purposes of the MiFID inducements rules.

Comments

⁷ CESR/07-228b, Inducements under MiFID, see Annex III



Procedures should embed arrangements for the record keeping of information disclosed to clients regarding inducements. More broadly, an investment firm should be able to demonstrate to the Competent Authority that its policies and procedures ensure the firm's compliance with its obligations under the MiFID inducements rules.

Good and poor practices - role of senior management and Compliance function

Good Practices

Example 1: An investment firm's procedures are developed with the direct involvement of senior management and the compliance function. Senior management approves the "inducements policy" based on a proposal by the relevant business units and the compliance function.

Example 2: The MiFID inducements rules are one of the "key regular control points" for the compliance function of an investment firm.

Comments

Article 9(1) of the Level 2 Directive requires investment firms to ensure that senior management (persons who effectively direct the business of the investment firm), and, where appropriate, the supervisory function, are responsible for ensuring that the firm complies with its obligations under MiFID. In particular, senior management and, where appropriate, the supervisory function shall be required to assess and to periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations under MiFID and to take appropriate measures to address any deficiencies.

One of the key obligations under Article 19 of MiFID is compliance with the MiFID inducements rules. Therefore senior management should at least approve the general policy the investment firm is going to apply to inducements, and inducements should be a key area in compliance function activities.

IV. Proper fees

Background

39. The types of third party payments defined by Article 26(c) of the Level 2 Directive as "proper fees" can be paid to or received by an investment firm without being subject to Article 26(b) of the Level 2 Directive.
40. Article 26(c) of the Level 2 Directive provides the following non exhaustive list of items falling under the definition of "proper fees", intended as payments which (1) "enable" or are "necessary" for the provision of the service and (2) "by their nature cannot give rise to conflicts with the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client":
 - custody costs;
 - settlement and exchange fees;
 - regulatory levies; and
 - legal fees.
41. Therefore, in determining whether an item not expressly listed in Article 26(c) of the Level 2 Directive may also fall within the "proper fees" regime, the two factors mentioned above should be considered. Particularly important is whether an item by its nature cannot give rise to conflicts with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interests of its clients. This is a test that needs

to be considered in the abstract, on the “nature” of the item; that is, not on the basis of whether the result of the payment has been to give rise to such a conflict. The possibility of a receipt of a standard commission or fee is of a nature to give rise to conflicts with the duty owed to clients. For example, it can provide an incentive to act in other than the best interests of the client because it is to the firm's advantage to make recommendations that will maximise the commission the firm will earn⁸.

Summary of findings

42. Most of the investment firms sampled did not mention any proper fees other than those listed within Article 26(c) of the Level 2 Directive.
43. Nevertheless, several items have been reported by some respondents. A list of the main items mentioned by respondents is provided below:
 - Audit/accountancy fees;
 - Brokerage fees;
 - Intra-group payments (including those based on commission sharing agreements);
 - Rebates from product providers belonging to the same group as the portfolio manager;
 - Legal, tax and strategic consulting fees;
 - Exchange/trading system/central depository membership fees;
 - Transaction reporting costs;
 - Stamp duties for securities transactions;
 - Compensation to tied agents;
 - Portfolio management fees;
 - Introducing broker fees;
 - Underwriting fees;
 - Postage costs;
 - Banking communication fees (SWIFT);
 - Information providers' fees;
 - Flat fees paid relating to shareholders' meeting duties, dividend distribution etc; and
 - Outsourcing commissions/fees.

CESR's reactions regarding those findings and key issues

44. Several items shown in the survey appear to belong to types of payments similar to the proper fees mentioned in Article 26(c) of the Level 2 Directive, i.e. they “enable or are necessary for the provision of investment services” and “by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients”. This is the case of all fees necessary for the provision of order execution services and which, by their nature, cannot give rise to conflicts with the best interests of the provider's clients. All kinds of fees paid by an investment firm in order to access and operate on a given execution venue should normally be considered as such (under the general category of settlement and exchange fees).
45. Specific types of custody-related fees such as those paid by the investment firm in connection with specific corporate events (shareholders' meetings, dividend distributions, etc.) can also be eligible for the proper fees regime. Additional items instrumental for the provision of the service to the client can be classified as proper fees, such as payments to information providers and to consultants for services related to the provision of the investment or ancillary service (for example if the intermediary gets tax advice about a placement it is going to manage).

⁸ See paragraphs 9 and 10 and Recommendation 3, CESR/07-228b, Inducements under MiFID, Annex III

46. It should be noted that all items considered as eligible for the proper fees regime must be paid by the investment firm to the third party. Otherwise it would be difficult for the nature of the payment (received by the investment firm), to meet the requirement of the absence of any potential conflict with the best interests of the client.
47. Nevertheless, in some cases payments by the investment firm are linked to other payments that clearly give rise to conflicts of interest and fall within Article 26(b) of the Level 2 Directive. This is the case, among others, of the rebates the investment firm may receive in connection with these payments. In other cases the items listed above could in specific situations assume such a nature that they can give rise to conflicts between the interests of the investment firm and its clients and therefore would not be proper fees under Article 26(c) of the Level 2 Directive.
48. Underwriting fees where the investment firm participating in the underwriting also sells the financial instruments issued to investors would generally fall within Article 26(b) of the Level 2 Directive, while if the firm is not selling/placing the financial instruments issued and is only performing all or part of the underwriting to the issuer, the underwriting fee will generally fall within Article 26(a) of the Level 2 Directive.
49. Investment firms should be aware in assessing payments that the category of proper fees is intended to be a narrow category. It was intended to provide a limited exemption from the application of the criteria for permissible payments under Article 26(b) of the Level 2 Directive and it is not to be used by firms to avoid the application of those criteria, particularly the disclosure requirement.
50. Some of the items mentioned by investment firms during the survey as proper fees certainly do not fall within Article 26(c) of the Level 2 Directive. That is the case of the compensation of its tied agents by an investment firm. This item is either outside the scope of Article 26 of the Level 2 Directive or within the scope of Article 26(b) of the Level 2 Directive. Under Article 23 of MiFID an investment firm is fully and unconditionally responsible for its tied agents. In these circumstances compensation of the tied agent can be seen as an internal payment within the firm which does not fall within the inducements rules. However, if the compensation is linked to a payment to the investment firm from a third party such as a product provider, the whole of the payment from the product provider (no matter how it is shared between the investment firm and its tied agent) has to be treated as a third-party payment under Article 26(b) of the Level 2 Directive.
51. Where the client is paying the investment firm directly, the payments fall within Article 26(a) of the Level 2 Directive, e.g. product charges (such as CIS subscription fees) or broker commissions paid directly by the client. However, broker commissions paid by the investment firm to a third party for an order that it has received from its clients will generally fall within Article 26(c) of the Level 2 Directive.
52. On the other hand, rebates from product providers to an investment firm providing portfolio management services represent a crystal-clear case of an item which is not a proper fee under Article 26(c) of the Level 2 Directive regime, since by their nature they can give rise to conflicts of interest and they are not necessary for the provision of the service.
53. All the references to intra-group money flows (considered as items different from the same type of payments occurring with an extra-group third party) as “proper fees” show a poor understanding of the relevant legal framework, since it should be clear that



payments made between distinct legal entities belonging to the same group are to be treated in the same way as payments outside the group⁹.

54. As for rebates to the introducing broker (within the group or not) paid by the investment firm, CESR has expressed¹⁰ the view that those payments fall within Article 26(b) of the Level 2 Directive, since they cannot be considered as necessary for the provision of investment services.

Tax Sales Credits

55. Some respondents raised the issue of the treatment of Tax Sales Credits. These are intra-group credits made between entities based in different tax jurisdictions which arise when two companies within the same group are involved in providing a service to a client. They are designed to ensure that income arising from cross-border transactions is attributed for tax purposes.
56. CESR is of the view that where the credits are in relation to the provision of an investment or ancillary service to the client, the credits will need to be classified under the inducements rules. To assess whether the credits will be categorised under Article 26(b) or Article 26(c) of the Level 2 Directive, the investment firm will need to take account of whether they are necessary for the provision of the investment service to the client and whether each credit by its nature can give rise to any incentive on the firm that will conflict with its duties to act in the best interests of its clients. If the credit is necessary for the provision of the investment service to the client and cannot give rise to a conflict, it may be treated as a proper fee. Otherwise the credit should be categorised under Article 26(b) of the Level 2 Directive and to be permitted, the credit must be designed to enhance the quality of the service and disclosed to the client prior to the provision of the service.

Question IV: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?

Question V: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?

Question VI: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?

V. Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the service provided to the client

Background

57. The MiFID inducements rules are not just linked to payments and non-monetary benefits which are designed to act as an incentive to encourage particular forms of behaviour. They cover a broad range of payments and non-monetary benefits that investment firms might provide or receive in the course of providing investment services

⁹ See the second paragraph of the section on 'General comments on responses to consultations' in the introductory section of CESR's 2007 recommendations on inducements under MiFID, Annex III.

¹⁰ See example VI (page 13), CESR/07-228b, Inducements under MiFID, Annex III.

to clients, regardless of their purpose. Aside from payments and non-monetary benefits provided to or by clients and the narrow category of proper fees, all other payments and non-monetary benefits related to the provision of an investment service or ancillary service to a client have to be disclosed to the client prior to the provision of the service and can only take place if:

- they are designed to enhance the quality of the relevant service; and
- they do not impair compliance with the firm's duty to act in the best interests of the client.

58. In its advice to the European Commission on the MiFID implementing measures (CESR/05-24c)¹¹, CESR said that "...inducements are a particular area of concern in relation to conflicts of interest." The conditions for permissible third-party payments and non-monetary benefits in Article 26(b) (ii) of the Level 2 Directive are designed to prevent client detriment arising from potential conflicts of interest arising from such payments and benefits. They seek to ensure that:

- (i) clients do not end up funding the purchase of goods and services by an investment firm which benefit the firm and not themselves; and
- (ii) the firm does not have a financial incentive to act in a way which is contrary to the best interests of the client.

59. Because of the link between this provision and conflicts of interest rules the implementation of the provision did not break wholly new regulatory ground in Member States. However, as indicated in the CESR 2007 recommendations, the cumulative conditions are a complement to rather than a substitute for the conflicts of interest provisions in MiFID. This is reflected in the requirement that the payments and non-monetary benefits are "...designed to enhance the quality of the relevant service to the client..." and the reference to "...the best interests of the client". The former term was something that was new in most Member States when MiFID was implemented.

60. Little was said in the formal documentation surrounding the MiFID Level 2 process about how the provision in Article 26(b)(ii) of the Level 2 Directive was intended to operate. The background note published alongside the draft implementing Directive in February 2006 limited itself to describing the article on inducements. This suggests the provision was not targeted at specific practices or arrangements but was designed to ensure that all relevant payments and non-monetary benefits were reviewed on a case by case basis to see whether or not they met the cumulative conditions.

Summary of findings

List of the types of payments and non-monetary benefits falling within Article 26(b) of the MiFID Level 2 Directive provided or received by firms

- 61. There was a significant degree of similarity between the types of payments and non-monetary benefits that investment firms in each Member State reported.
- 62. Third party payments are very common for services linked to the distribution of financial instruments, in particular the distribution of units in CIS. Investment firms reported receiving rebates of entry and management fees from operators of CIS, with the latter being paid on an ongoing basis. Such payments were being made to firms that distribute financial instruments, provide investment advice and provide portfolio management

¹¹ See CESR/07-228b, Inducements under MiFID, Annex III.

services. Some investment firms also said that in relation to units in CIS they were receiving rebates of custody fees and performance fees.

63. Other circumstances in which payments are made/received in relation to distribution that were frequently mentioned in the responses to the questionnaire were structured products and the placing of financial instruments. Originators of structured products pay the distributors through a variety of mechanisms including rebates of management fees and selling the products to the distributors at a discount to the amount charged to the client. Likewise when other financial instruments are placed the issuer pays an investment firm to place the instruments.
64. Aside from distribution, other circumstances mentioned in which payments and/or non-monetary benefits were made and received were:
- **Introducing.** Investment firms provide and receive payments and non-monetary benefits for the introduction of clients/business. This includes payments and benefits to and from entities that are not authorised financial service firms.
 - **Order flow.** Several instances were cited of payments made/received which appeared to be linked to order flow including rebates on brokerage fees, rebates of settlement fees and the payment of platform fees for electronic trading.
65. There were two main industry practices observed in relation to non-monetary benefits:
- The first was in relation to the distribution of products. Operators of CIS provide training for the staff of investment firms to help them to understand the funds they operate. They may also provide other non-monetary benefits such as marketing material, research, hardware and software and other IT products.
 - The second was where brokers provide non-monetary benefits to investment firms providing portfolio management services in addition to providing the service of the execution of orders. These benefits can include the provision of research, data feeds and IT software and infrastructure.

CESR's reactions regarding those findings and key issues

66. As indicated above, the inducements rules cover a wide range of payments and non-monetary benefits including discounts (which are indirect payments). It was therefore not surprising that firms reported making and receiving a wide range of third party payments or that many of these were linked to the distribution of financial instruments. The distribution of financial instruments often involves more than one investment firm thereby creating a flow of payments.
67. The nature of payments made and received by investment firms are on both a one-off and an ongoing basis in relation to services provided to clients. However, in instances where the services which have been provided to the client are of a one-off nature, the expectation of ongoing payments to be made/received over a period of time can exacerbate the risk of the firm not meeting the conditions under Article 26(b) of the Level 2 Directive. CESR is of the opinion that firms ought to put in place particularly robust measures to manage this exacerbated risk.
68. In its 2007 recommendations CESR said that a payment to an investment firm that introduces a client to another investment firm can be considered to be designed to enhance the quality of service to the client. The same logic should also apply to introducers that are not authorised investment firms. If an investment firm is to make such a payment it will also need to be disclosed to the client and to not impair the investment firm's duty to act in the best interests of the client.

Question VII: Do you agree with CESR's view that in the case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?

Summary of findings

Main practices in ensuring conflicts of interest are managed so that third-party payments and non-monetary benefits do not conflict with the duty owed to clients to act in their best interests and situations in which, and reasons for which, firms consider that such payments and benefits are designed to enhance the quality of the service

69. Many respondents to the questionnaire said that the way they ensure that providing or receiving payments and non-monetary benefits to or from third parties does not cause them to act contrary to the best interests of their client is through the application of their conflicts of interest policy. Some respondents also said that for conflicts policies to be effective the role of the compliance function within a firm was essential.
70. Going beyond the application of conflicts policies and the role of the compliance function, the following specific methods of managing potential conflicts caused by third party payments and non-monetary benefits were mentioned by respondents to the questionnaire:
 - internal procedures separating functions where conflicts of interest may arise, such as those persons responsible for selecting the CIS a firm will provide to clients and/or negotiating rebate agreements with the promoters of CIS (or other parties connected to the CIS) and those who sell these products or otherwise use them e.g. portfolio managers who purchase them on behalf of clients;
 - remuneration policies, under which the salary of persons who, for example, sell or use CISs is not determined by the use of some or all of the said CISs;
 - passing to clients rebates received from third parties;
 - negotiating the same level of rebates for each CIS, regardless of who its promoter is;
 - not charging any management fee to clients whose assets are under management when they invest in a CIS;
 - implementing Chinese Walls to prevent “leaks” of information about the payments received to the departments which provide the service to the client so that advisors, sales staff and portfolio managers in contact with clients do not have access to information about the agreed rebates; and
 - applying a strict “best execution policy” to ensure brokers are chosen on the basis of their execution services and not the quality of the research they provide.
71. In addition to the best execution obligation, some respondents to the questionnaire also mentioned that compliance with certain other conduct of business rules in MiFID also had a role to play in managing conflicts. The appropriateness test and the suitability test were most frequently mentioned in this respect.

72. A variety of justifications were put forward as to why third-party payments and non-monetary benefits were designed to enhance the quality of the service to clients (although most justifications tended to ignore the ‘designed to’ part of the requirement focusing more directly on how firms believed they did enhance the quality of the service). The justifications included:

- the receipt of payments from the producers of financial instruments (mainly CIS being mentioned) enables the investment firm to offer its clients access to a wider range of financial instruments;
- the payments cover costs that otherwise would have to be charged to clients, such as fund-picking fees (remuneration for the work of choosing and monitoring CISs, and which is not currently covered by the management fee paid by the client) or the costs relating to providing information on the financial instruments sold by the firm (costs covering product fact sheets, etc.);
- the payment is remuneration for the provision of a distribution network;
- the receipt of higher payments from an in-house CIS reflects the fact that the investment firm participates in the creation of the CIS through its knowledge of its clientele and of the types of product that might meet their expectations;
- the rebates of the brokerage fees or settlement fees are remuneration for the task of monitoring or ‘prematching’ orders carried out by the beneficiary of the rebate;
- the payment of a commission to a business or client introducer enables the client to use the services provided by the firm that pays the commission;
- the receipt of ‘soft commissions’ in the form of research enhances the beneficiary firm’s ability to follow the markets or the securities covered by the research;
- the receipt of ‘soft commissions’ in the form of training sessions enables the investment firm’s sales staff to have a better knowledge of the products that are covered in the training and that they sell to clients;
- payments from product providers remunerate distribution services, advice services and post-sale assistance;
- payments from product providers are used to finance high-quality advice to the investment firm’s clients without separately charging the client for this service; and
- payments serve to build up and preserve effective infrastructure of high quality, such as connections to trading facilities, IT-tools, information on financial instruments beyond what is required according to MiFID.

73. Some of the responses to the questionnaire suggested that some investment firms do not consider the “designed to enhance” criterion as separate to the duty to act in the best interests of the client.

CESR’s reactions regarding those findings and key issues

74. First of all, CESR wishes to highlight that there are at least two highly important instances where payments and non-monetary benefits received can give rise to very significant potential conflicts:

- where investment firms providing investment advice and/or general recommendations receive payments and/or non-monetary benefits from product providers;
 - where investment firms providing portfolio management services receive payments and/or non-monetary benefits from product providers and/or firms handling (i.e. executing or receiving and transmitting) orders.
75. Given the practical importance of the above situations, much of the following discussion, both in the present Chapter V and in Chapter VI on disclosure, including the examples of good and poor practices, focuses on product distribution (including advisory and portfolio management services) and order handling (order execution and order reception-transmission).
76. CESR agrees with respondents to the questionnaire that an effective compliance function and adherence to adequate conflicts management policies and procedures are key to investment firms complying with the obligation to ensure that third-party payments and non-monetary benefits do not impair firms' compliance with their duty to act in the best interests of their clients. However, it observes that this should include appropriate monitoring and controls to deal with the specific conflicts that such payments and benefits a firm provides or receives can give rise to (see Chapter III, in particular §§34-38).
77. CESR also agrees that an investment firm's compliance with certain conduct of business rules such as the suitability test and the best execution regime can help to ensure that conflicts of interest are managed effectively and the risk of client detriment diminished. However, it recalls that firms must also comply with the MiFID inducement rules as a separate and important piece of the regulatory framework.
78. Although many methods of conflicts management were mentioned by investment firms, not all of them would appear to be effective in managing conflicts. For example, some firms said that information about the levels of rebates from product providers was kept away from those involved in managing clients' portfolios. However, given the disclosure requirements in relation to such payments it seems unlikely that those managing client portfolios would not be able to inform themselves about the levels of rebates attached to different products. Other firms indicated that they were remunerated only by product providers and did not charge any management fee to clients whose assets are under management when they invest in a CIS. Such a measure does not appear to address conflicts that could arise due to different levels of third party payments depending on the CIS because the firm can choose to invest in products that are lucrative for itself instead of other comparable products.
79. The findings of the survey show that the "designed to enhance" wording is causing some degree of uncertainty amongst investment firms. This has several aspects to it:
- First, investment firms generally find it difficult to get a grasp on "designed to" and therefore focus on actual enhancement;
 - Second, some investment firms do not know what the wording adds over and above the requirement to act in the best interests of their client; and
 - Third, there does not appear to be a common approach amongst investment firms in relation to how the words apply in determining when it is acceptable to provide or receive third party payments or non-monetary benefits.
80. CESR acknowledges that the application of the test might not always be straightforward, although paragraph 15 of its 2007 recommendations specifies that *"the use of the word 'designed' makes clear that a judgment about a fee or payment, or arrangements for fees or payments (including non-monetary benefits), can be made at the time the arrangement is*



proposed, rather than only once a payment has been made”. Therefore, as CESR also cautioned in 2007, this should not be used as an “excuse for not considering the test or interpreting it in such a wide fashion that it becomes meaningless”.

81. Several of the reported justifications focus on the fact that payments imply that additional or higher quality services are provided or an investment firm can offer a client access to a wider range of financial instruments. If this really is the case (which should be assessed on a case-by-case basis having regard to factors set out in CESR’s 2007 recommendations¹²), it is consistent with what CESR said in recommendation 5(b) in its 2007 recommendations with reference to distribution services, although it also makes clear that the other elements of the rules have to be complied with for a payment to be permissible.
82. Some of the justifications given do not appear to be acceptable. The fact that the payment covers costs that would otherwise have to be charged to the client is not sufficient for a payment to be judged to be designed to enhance the quality of the service. The client is likely to end up paying the costs no matter how they are charged, directly or indirectly.
83. Several respondents apparently continue to believe that the MiFID inducement rules do not apply, or apply differently, in relation to payments made within a group. CESR made clear in its 2007 recommendations¹³ that the mere existence of a group relationship was not by itself a relevant consideration to how the test applies. Equally, however, the criteria and reasoning which enable an investment firm to determine that payments and non-monetary benefits provided to or by entities outside of the group must also be applied to intra-group payments and benefits.

Question VIII: Do you have any comments regarding CESR's view that measures such as an effective compliance function should be backed up with appropriate monitoring and controls to deal with the specific conflicts that payments and non-monetary benefits provided or received by an investment firm can give rise to?

Question IX: What are your comments on CESR's view that product distribution and order handling services (mentioned in §74) are two highly important instances where payments and non-monetary benefits provided or received can give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?

Question X: What are your comments on CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?

Good and poor practices: acting in the best interests of the client and designed to enhance the quality of the service provided to the client

Good practices

Example 1: An investment firm providing portfolio management services receives ‘soft commissions’ including research, technical services and information technology from firms who execute client

¹² See recommendation 4, CESR/07-228b, Inducements under MiFID, Annex III.

¹³ See CESR/07-228b, Inducements under MiFID, Annex III

orders. The receipt of these non-monetary benefits meets the conditions in Article 26(b) of the Level 2 Directive.

Example 2: An investment firm providing portfolio management services receives 'soft commissions' from a custodian where its clients have deposited their assets and which also acts as executing broker. These commissions take the form of IT facilities (systems and links) enabling the firm to know in real-time the amount of the assets of those clients and the status of execution of investment decisions it has taken. The firm justifies such commissions by the fact that they enhance the quality of the portfolio management service it provides to those clients, thanks to the accuracy of the information at its disposal. Moreover, these arrangements do not impair compliance with the firm's duty to act in the best interests of its clients.

Comment

It can be legitimate for a firm providing portfolio management services to receive soft commissions from a firm who is providing it with the service of the execution of client orders, as described in example 1 above. However, the receipt of these non-monetary benefits must meet the conditions in Article 26(b) of the Level 2 Directive. Particular attention has to be paid to avoiding a situation in which the receipt of the non-monetary benefits could impair a firm's duty to act in the best interests of its clients because they make a portfolio manager reliant upon the soft commissions received from a particular brokerage firm (See Q112 of the EC MiFID Q&As).

It can be legitimate for a firm providing portfolio management services to receive the type of soft commissions as described in example 2 above, in so far as this access to real-time information goes beyond what should be the normal information at the disposal of any portfolio manager. All the other conditions set up under Article 26(b) must also be complied with. CESR is of the opinion that it would probably be less easy to justify why 'hard commissions' paid in such circumstances are designed to enhance the quality of the portfolio management service provided to the client.

Poor practices

Example 1: An investment firm expects to receive a substantial flow of ongoing payments from a third party (a product provider) in relation to distribution services for a range of financial instruments provided to clients on a one-off basis. The firm structures its sales force to push those products over other comparable products that the firm also offers and for which it receives less lucrative, one-off payments. The costs of the products for which the firm receives ongoing payments are significantly higher for the end client than those for products linked to one-off payments .

Example 2: An investment firm distributes structured products. It is paid through discounts (it buys the products from the distributors at a discount to the amount charged to its clients). The firm does not classify such third party payments under Article 26(b) of the Level 2 Directive.

Example 3: An investment firm distributes financial instruments and provides investment advice to clients. These services are remunerated indirectly through rebates from product providers. It manages conflicts of interest that may arise due to the third-party payments received mainly by applying strong suitability tests.

Example 4: An investment firm providing the investment service of investment advice as well as distributing financial instruments receives various levels of rebated commission from individual product providers. The investment firm's advisers and sales staff are rewarded, at least in part, in relation to the levels of commission generated by the recommendations/sales they individually make to clients.

Example 5: An investment firm providing portfolio management services and/or distributing financial instruments receives rebates of brokerage and custody fees when the volumes of business sent to firms executing client orders and/or providing custodianship reaches set levels.



Example 6: An investment firm providing portfolio management services receives rebates from product providers whose CIS it invests in on behalf of its clients. These rebates are not returned to the client, and the rebates received for picking funds provided by a group company are significantly higher than those provided by third parties.

Comment

CESR is of the opinion that where an investment firm is receiving a payment there has to be an expected benefit to the relevant client (or relevant clients if the assessment is being made at the level of the service) in order for the payment to satisfy the requirement of being designed to enhance the quality of the service. In the first example under poor practices, the firm appears to be acting against its clients' interests by placing its interests ahead of the clients' interests and exploiting the conflict. Furthermore, the ongoing payments do not seem to be benefiting the clients' interests.

CESR is also of the opinion that discounts (which are indirect payments) should be regarded as being third party payments within the meaning of Article 26(b) of the Level 2 Directive.

Recital 39 of the Level 2 Directive makes clear that indirect payments to firms providing investment advice can be legitimate. However, this is only the case where the firm takes steps to ensure that the incentives it faces because of the varying levels of commissions do not result in investment advice which is biased and is not in the best interests of the client. The most relevant specific control here is the arrangements that an investment firm has for ensuring compliance with the rule requiring suitability assessments in relation to investment advice under Article 19(4) of MiFID. But to avoid bias firms will also need to think whether there are additional steps they need to take to ensure that they are acting in the best interests of their clients and effectively managing the conflicts of interest. Without such additional steps, the sole reliance on the suitability test to manage conflicts of interest, as in example 3, is likely to be a poor practice. An investment firm could avoid this conflict by charging clients directly for investment advice.

Where, as in example 4, individuals providing advice and/or distributing financial instruments can obtain a higher reward for recommending or selling particular types of products or the products of a particular provider, this creates a clear danger that their advice and/or sales pitch will not serve the best interests of the client. Therefore the rewards of advisers and sales staff should not be linked directly to the commissions generated through the sales of products which result from the recommendations they give (although rewards may need to be structured in a way which avoids creating an incentive to recommend products which involve the least time and effort for advisers).

A rebate on fees such as brokerage and custody fees constitutes a third-party payment under the MiFID inducements rules. Where a rebate is paid for achieving a set level of business as in example 5, there is a clear incentive for a firm to use a particular broker or custodian which is likely to impair compliance with a firm's duty to act in the best interests of the client. Therefore it is doubtful that the receipt of rebates on brokerage and custody fees when business reaches a set level can satisfy the requirements of the MiFID inducements rules.

In the poor practice illustrated in example 6, it is difficult to see in what circumstances the arrangements could be justified under the MiFID inducements rules. In its 2007 recommendations CESR has already said that it is difficult for a portfolio manager to justify retaining payments from product providers. A higher level of payments from product providers within the same group is unlikely to enhance the quality of service.



VI. Payments and non-monetary benefits authorised subject to certain cumulative conditions - Disclosure

Background

84. Clear prior disclosure to the investment firm's client is one of the conditions for payments and non-monetary benefits to or from a third party to be permitted under Article 26(b) of the Level 2 Directive.
85. In its recommendations on inducements under MiFID, CESR recalls that Article 26(b)(i) of the Level 2 Directive is clear in setting out the information that an investment firm should provide, that is: "the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount". An investment firm may, however, by virtue of the final paragraph of Article 26, disclose only the "essential terms of the arrangements" provided that further details are disclosed at the request of the client and the client is informed of this right.
86. In CESR's view, a generic disclosure which refers merely to the fact that the investment firm may or will receive inducements is not sufficient to enable the investor to make an informed decision and therefore will not be considered as meeting the requirements of Article 26(b)(i) of the Level 2 Directive. Indeed, such a disclosure cannot be considered as providing the "essential terms of the arrangements" referred to in Article 26 of the Level 2 Directive.
87. In order to contain the "essential terms", a summary disclosure must provide adequate information to enable the investor to relate the disclosure to the particular investment or ancillary service that is provided to him, or, to the products to which it relates. This is necessary to enable the client to make an informed decision on the investment¹⁴.
88. Where more than one investment firm is involved in the distribution process, each entity that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients in relation to the services that it provides¹⁵.
89. Disclosures relating to third party payments and non-monetary benefits should also comply with Article 19(2) of MiFID, according to which "all information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading"¹⁶.

Summary of findings

Summary disclosures

90. Most investment firms disclose third party payments made or received in a summary form. Detailed information on such payments is usually only provided at the request of the client. Sometimes however, summary information is automatically supplemented by detailed information provided through a product fact sheet given at the point of sale to a client before he decides to buy or subscribe a particular financial instrument.
91. The content of these summary disclosures varies from investment firm to investment firm. For instance, some summary disclosures cover the different types of third party payments and non-monetary benefits that a firm provides or receives and state that the client can ask for more information about such payments and benefits. This is not

¹⁴ See Recommendation 6, CESR/07-228b, Inducements under MiFID, Annex III

¹⁵ See Recommendation 6, CESR/07-228b, Inducements under MiFID, Annex III

¹⁶ This includes the conditions which information for retail clients must comply with to meet these criteria as set out in Article 27 of the MiFID Level 2 Implementing Directive.

observed in all situations. Indeed, some firms' summary disclosures only recognise the fact that the firm provides and receives payments and non-monetary benefits (without mentioning the types of possible payments and non-monetary benefits for each type of service provided or class of instrument concerned¹⁷, when relevant) and/or do not inform the client that he may ask for more information about those payments and non-monetary benefits.

92. On rare occasions, firms mention that they receive higher rebates for distributing in-house (including in-group) products than for distributing third party products.

CESR's reactions regarding those findings and key issues

93. When talking about summary disclosures, three aspects should be taken into account: the content of the summary disclosure; the way in which it is disclosed; and the moment when it is disclosed.
94. Regarding the content, Article 26 of the MiFID Level 2 Directive states that an investment firm can disclose the essential terms of the arrangements relating to third party payments and non-monetary benefits in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking.
95. In its 2007 recommendations on inducements under MiFID, CESR said that a summary disclosure must provide adequate information to the client to enable him (i) to relate the disclosure to the particular investment or ancillary service that is provided to him, or to the products to which it relates, (ii) to make an informed decision whether to proceed with the investment or ancillary service and (iii) to decide whether to ask for the full information¹⁸.
96. CESR wishes to clarify that this means that - even when provided in a summary form - the information should cover all types of third party payments and non-monetary benefits provided or received, in relation to the service or services to be provided to the client, in order to enable him to make an informed decision. For each investment or ancillary service provided, the client should be provided ex ante with sufficient details in order to understand readily how the firm is incentivised to act in a specific manner. For example, if an investment firm receives different levels of rebates for distributing UCITS investing in bonds and UCITS investing in shares or in-house (including in-group) products in comparison with third party products, this should be stated.
97. The investment firm should also mention the types of third parties from which it receives or to which it provides payments or non-monetary benefits. Again, the information given should enable the client to make an informed decision in relation to the service.
98. In order for this summary information to be clear, comprehensive, accurate and understandable as well as not misleading, CESR believes that, with regard to third party payments made or received by the investment firm:
 - the information should at least include a reasonable band range of payments, in order for the client to be aware of the possible level of inducements;
 - when the exact amount of third party payments made or received or the method of calculating that amount¹⁹ varies depending on:

¹⁷ By "class of instrument", we mean the broad categories of financial instruments: shares, bonds, UCITS...

¹⁸ See paragraphs 9 and 10 and Recommendation 6(a), CESR/07-228b, Inducements under MiFID, Annex III

¹⁹ "Method of calculating that amount" should be understood as the basis and the percentage applied.

- the class (or family) of instrument, then the information should not only be given per service provided but also per class of instrument covered (or, within a class of instrument, per family of instrument where differences are material within the class)²⁰; or
 - the provider of the financial instruments (third party products versus in-house or in-group products, or products of one third party versus products of another third party), then the information should indicate any material differences.
99. In the summary disclosure clients should always be told that they can request further information regarding third party payments and non-monetary benefits made or provided and be told how or to whom they can make such a request.
100. Summary disclosure should thus provide enough information to the client to enable him to understand the situation, while the detailed disclosure goes a step further, providing the client with more in-depth information. For example:
- while bands may be used in summary disclosures, it is the exact amount of payments and non-monetary benefits or method of calculating that amount (where the amount cannot be ascertained ex ante) that should be indicated in the detailed disclosure;
 - a summary disclosure may mention that the investment firm receives research from brokers to whom it transmits orders for execution, while the detailed disclosure should contain more detail, e.g. an estimate of the value of the investment research.
101. Regarding the form of the summary disclosure, here again, one can refer to the requirement - under Article 26(b)(i) of the Level 2 Directive - that the information should be clear, comprehensive, accurate and understandable. It should also be noted that, as for any other information, disclosures relating to third party payments and non-monetary benefits must equally be fair, clear and not misleading, as required under Article 19(2) of MiFID ²¹.
102. CESR believes that this means that the language used to inform clients on third party payments and non-monetary benefits should be unambiguous, as otherwise this might hinder clients' understanding of the incentives linked to the service or product. The directive is silent on the media through which disclosures can be made. However, firms need to be sure that whatever medium they choose, it is fair to the client, particularly if the medium is not a durable one. The media chosen should also be appropriate to enable the competent authority to monitor compliance with the MiFID inducements rules²². CESR believes that it is good practice to use a durable medium (within the meaning of Article 2(2) of the Level 2 Directive).²³
103. Investment firms' initial disclosures to clients regarding third party payments and non-monetary benefits, made either in summary or detailed form, should always be made prior to the provision of the relevant service. In order to determine when they should make the required disclosures, firms should keep in mind that the timing of the disclosure should provide sufficient opportunity for the client to make an informed decision whether to proceed with the investment or ancillary service and to decide whether to request additional detailed information. Relevant considerations are likely to

²⁰ "Class of instrument" means here the broad categories of financial instruments: shares, bonds, UCITS etc. "Family of instrument" means here e.g. UCITS investing in bonds, UCITS investing in shares, UCITS investing in money market instruments etc.

²¹ This includes the conditions which information for retail clients must comply with to meet these criteria as set out in Article 27 of the Level 2 Directive.

²² The general requirement under Article 13(6) of MiFID.

²³ This is based on Article 29 (4) of the Level 2 Directive which sets out the general requirements for how information about the firm and its services and charges should be provided to clients.



include those in recital 48 of the Level 2 Directive on the provision of information in good time.

Question XI: Do you have any comments on CESR's view of the summary disclosure rule under Article 26(b)(i) of the Level 2 Directive (including when such a disclosure should be made)?

Good and poor practices - summary disclosure

Good practices

Example 1: In the terms and conditions that all clients of an investment firm providing all types of investment and ancillary services receive at the beginning of the relationship, the firm indicates;

- that it receives payments from issuers of financial instruments in the context of Initial Public Offerings or for structured or OTC products. It indicates that these third party payments can take different forms. They usually represent an amount of up to 3.5% of the value of the issue placed by the firm, although in specific cases they can also consist in rebates of management fees due for the related financial instruments;
- that it receives third party payments from CIS providers and that these payments consist of rebates of the management fees due to the relevant CIS. To indicate the size of these payments (including variations depending on the CIS provider or CIS family where relevant and material), a reasonable band range is provided.
- that it makes payments to third parties that help to start, conclude or maintain a business relationship between the firm and clients (introducing fees). It specifies that these payments are one-off payments, representing a maximum of 1.25% of the assets brought to the firm for portfolio management, and that on-going payments of a maximum of 0.30% of the assets under portfolio management can also be made; and
- that the client can receive more detailed information on request (as well as to whom this request can be made).

Comments

Example 1 of a good practice of a summary disclosure provides clients with clear, prior disclosure about the existence, the nature and the amount or method of calculating that amount of the different types of third party payments that the investment firm makes or receives, as required by Article 26(b)(i) of the Level 2 Directive (except for any soft commissions received which are not mentioned). Such disclosure should help clients to make an informed decision because it enables them to relate the payments to the particular services that are provided and to the relevant products.

Poor practices

Example 1: An investment firm which provides and receives third party payments and non-monetary benefits discloses to a client prior to the provision of a service that it may provide to or receive from third parties fees, commissions or non-monetary benefits (the firm provides no other disclosure under the MiFID inducements rules prior to the provision of the service).

Example 2: An investment firm providing a wide range of services, covering different types of financial instruments, discloses that *"In order to enhance the quality of the services provided to our clients, we make or receive third party payments. These payments do not conflict with the interests of our clients, as they are managed by our conflicts of interest policy"*.

Comments

Example 1 of a poor practice of a summary disclosure is too generic to enable the client to make an informed decision. Indeed, as stated by CESR in its 2007 recommendations about inducements under MiFID, the summary disclosure should contain enough information to enable the client to make an informed decision. In addition, the summary disclosure should also always contain clear wording that the client has the right to receive exact information regarding third party payments and non-monetary benefits from the investment firm.

Apart from the fact that the essential terms of the arrangements relating to third party payments in example 2 of a poor practice are not disclosed, the language used in this disclosure is misleading. Such information cannot be seen as enabling the client to be appropriately aware of the incentives for the firm that may arise due to third party payments. Such language also discourages him from requesting further details, and fails to mention that the client is entitled to request additional information.

Summary of findings

Detailed disclosures

104. According to the investment firms surveyed, very few clients have requested detailed information after having received summary information and it is usually only on request that firms have provided such detailed information.
105. The examples of detailed disclosures provided by the investment firms surveyed usually contain information about third party payments made by CIS providers to firms that distribute their products, where the exact amount of the payment received or the method of calculating that amount (where it cannot be ascertained ex ante) is commonly mentioned.
106. In some less frequent situations, the detailed disclosure is not limited to third party payments made by CIS providers to investment firms that distribute CIS but also covers third party payments made by other types of product providers. In these cases, the firms surveyed provide detailed information automatically at the point of sale, through the provision to the client of a product fact sheet or a subscription form that complements the generic disclosure made at the beginning of the relationship with the client in the general terms and conditions or in the client “information pack”.

CESR’s reactions regarding those findings and key issues

107. To be able to provide detailed disclosure, as required under Article 26(b)(i) of the Level 2 Directive, CESR is of the opinion that investment firms should set up the necessary organisational arrangements and procedures.
108. CESR also believes that in order to be accurate, detailed disclosure should not only mention all the types of third party payments and non-monetary benefits provided or received but also should always provide the exact amount of the third party payments and non-monetary benefits. In cases where the detailed disclosure is provided prior to the provision of the service to the client and where the amount of the payments cannot be ascertained before the provision of the service, a reasonable band range of the payments may be provided in the detailed disclosure, in conjunction with the method of calculating the amount. Where the client requests a detailed disclosure after the provision of the service, then the disclosure should provide the exact amount of the third party payments and non-monetary benefits. Detailed disclosures should be written concisely in unambiguous language.

Question XII: What are your comments on CESR's views about detailed disclosures?

Good and poor practices- detailed disclosure

Good practices

Example 1: When requested to do so by a client with respect to a particular CIS, an investment firm providing investment advice to its clients discloses ex ante that it will receive rebates on entry fees as follows from the provider of the CIS (the firm does not receive any other third party payments in relation to this product):

Balance	Name of CIS	Currency	Unit price	Estimate	Client no.	ISIN code	Type of instrument	Rebates received on entry fees %	Estimate of the benefit in €
100	...	EUR	10	1000	...	LU...	...	0.50%	5
...

Comments

Example 1 can be regarded as a good practice of a detailed disclosure, as it enables the client to know, prior to the provision of the service, the exact amount of the third party payment that the investment firm shall receive. The additional information lies in the precise estimate of the benefit. CESR acknowledges that in practice, such an ex ante detailed disclosure is not likely to be possible for all investment services. For example, this may not be feasible when the service provided to the client is portfolio management.

Poor practices

Example 1: An investment firm provides its clients with broad information about the fact that it makes or receives third party payments. It also informs its clients that they can request further details about such payments. When a client requests further details, the firm does not disclose the exact amount of third party payments made or received. Instead, it resorts to bands to disclose third party payments.

Example 2: An investment firm providing portfolio management services to retail clients informs them, in documentation provided to them at the beginning of the client relationship, of the fact that it provides or receives third party payments and non-monetary benefits (without giving more details). Further information about those third party payments and non-monetary benefits is disclosed in the reports it sends to its clients regarding the management of their portfolios.

Comments

In relation to the poor practice in example 1, CESR considers that detailed disclosure should provide the exact amount of third party payments.. The use of bands when requested to provide detailed disclosure cannot be regarded as a good practice in this instance, as it clearly does not meet the requirements of Article 26(b)(i) of the Level 2 Directive, except where the detailed disclosure is provided prior to the provision of the service to the client and where the amount of payment could not be ascertained before the provision of the service. In such a situation, a reasonable band range of the



payment may be provided in the detailed disclosure, in conjunction with the method of calculating the amount.

The approach in example 2 is a poor practice. The disclosure made to the client prior to the provision of the service does not provide sufficient information to enable the client to make an informed decision about whether to proceed with the investment or ancillary service. The required information is disclosed to the client after the provision of the relevant investment service (in this case, the portfolio management service). The investment firm thus does not meet the requirements of Article 26(b)(i) of the Level 2 Directive. This firm also appears to confuse two distinct requirements: the requirement to disclose third party payments and non-monetary benefits in advance, according to Article 26(b)(i) of the Level 2 Directive, and the reporting requirements set up by Article 41 of the Level 2 Directive. Those two types of requirements can be complementary but are not alternatives.

Summary of findings

Use of bands²⁴

109. Many investment firms (although not all of them), use bands in their summary disclosures, mainly regarding payments received or made in relation with the CIS that they distribute. Bands are sometimes also used in relation to the distribution of structured products, even if less often (here, firms commonly mention instead a maximum percentage that they can receive).
110. The investment firms surveyed indicated that they use bands because the exact amount cannot always be calculated prior to the provision of the related service and because it avoids the need to reprint literature when individual payments change.
111. A very limited number of investment firms disclose two types of ranges, making a distinction between what they receive when distributing in-house or in-group CIS and what they receive when distributing third party CIS.
112. The ranges between bands vary from investment firm to investment firm as well as according to the class or family of financial instrument concerned. For CIS, the ranges can sometimes be very wide (for example, between 0 and 80%), while they are usually narrower for structured products, in particular structured OTC products.
113. Bands are not usually used by investment firms in their detailed disclosures.

CESR's reactions regarding those findings and key issues

114. The use of bands in summary disclosures is permissible as long as the information enables an investor to make an informed decision whether to proceed with the service or to ask for more information. In detailed disclosures, the amount of the third party payments (or the method of calculating them) should be disclosed ex ante to the investment firm's clients. In such disclosures the use of bands should thus be limited to those situations where a firm cannot provide the amount prior to the provision of the relevant service.
115. When using percentages, investment firms should indicate clearly to what payment the percentage applies in order to ensure their disclosure is fair, clear and not misleading. For example, firms should not solely mention that when selling a given family of CIS they receive third party payments between x and y % but be more precise

²⁴ See question 3.3 of the CESR Inducements questionnaire, Annex II.



by indicating that they receive third party payments representing an amount between x and y % of the management fee due to the CIS provider.

116. The goal of the information being to enable clients to make an informed decision, CESR is of the opinion that investment firms should take particular care to ensure that when using bands the information presented is meaningful and not misleading. This can be illustrated by two examples:
- First, bands might not provide clients with information about the actual dispersion of payments. The presentation of two identical bands for two different families of products might hide the fact that in one case payments are clustered at the bottom end of the band whilst in the other they are clustered at the top end of the band.
 - Second, bands might not reveal important differences between similar products. A band quoted for a particular type of equity CIS distributed by an investment firm might hide the fact that the payments in the upper part of the band relate to in-house or in-group products whilst those at the lower part of the band relate to third party products. The information given should allow clients to be able to identify which financial instruments could give rise to the most significant potential conflicts of interest.
117. When disclosures are made by indicating the maximum level of third party payments (for example, the firm discloses that it receives third party payments of a maximum 50% of the management fee due to CIS provider), conceivably the payment could be anything from 0 to 50%. In practice, payments seem to be closer to the maximum than to the minimum possible (0). CESR believes that maximum levels should be treated like bands (maximum 50% should be understood as between 0 and 50%). Maximum levels pose a risk to the investment firm that the band is too broad, and therefore firms must act with care when using them. In particular, CESR is of the opinion that firms should not give their clients a false impression by using maximum levels where in fact the minimum level of third party payment is not 0. For example, if the firm says that it receives third party payments of a maximum 50% of the management fee due to the provider of a CIS and in practice it receives between 20% to 50%, CESR believes that it is a poor practice for the firm to make such a disclosure and it should instead say that it receives from 20% to 50% of the management fee due to the CIS provider.

Question XIII: Do you have any comments on CESR's views on the use of bands?

Good and poor practices - use of bands

Good practices

Example 1: An investment firm distributing in-house (including in-group) and third party CIS as well as third party structured products provides summary disclosure to its clients indicating that it receives the following types of third party payments from the relevant product provider (these are the only rebates it receives):

- an annual payment between 0.5 and 1.7% of the assets under management for in-house CIS;
- an annual payment between 0.125 and 1.5% of the assets under management for third party CIS;
- a one-off payment up to 4% of the value of the issue for structured products.

Comment

The information provided in example 1 of a good practice can be seen as being comprehensive, accurate and understandable (assuming that the distribution of payments within the ranges is not skewed with respect to different families of CIS). The range applied between bands can be regarded as reasonable and enables the client to properly identify where there could be conflicts of interest.

Poor practices

Example 1: An investment firm distributing in-house (including in-group) and third party CIS provides summary disclosure in a document indicating that it receives the following types of third party payments from the relevant product provider (these are the only rebates it receives):

- an annual payment between 50 and 85% of the management fees for in-house CIS;
- an annual payment between 25 and 60% of the management fees for third party CIS.

In separate documents provided to the client subsequently, the client can see that management fees for in-house CIS range from 1 to 2% and management fees for third party CIS range from 0.5 to 2.5%.

Example 2: An investment firm provides its clients through its general terms and conditions of the third party payments it receives, using bands. For CIS, the firm discloses that the level of third party payments it receives amounts to between 0 and 80% of the management fees due to the relevant CIS provider.

Example 3: An investment firm provides summary disclosure to its clients indicating that it receives third party payments that represent between 20 and 80% of various types of fees paid by the clients. In practice, it appears that for third party products, the rebates represent between 20 and 50%, while for in-house products, the rebates are between 60 and 80%.

Comment

In example 1 of a poor practice, the firm is not enabling the client to have a clear picture of the remuneration it receives for the distribution of CIS because the relevant information for inducements purposes is given in different documents at different times.

In example 2 of a poor practice, the range between bands used by this investment firm seems too large to enable the client to have a clear view of how much the firm is earning for its services. The firm is not providing any useful information to its clients and is not disclosing how much the management fees are. Moreover, by using such a large range, the firm does not provide its clients with information about the differences between the percentages of rebates it receives depending on the family or origin of the CIS. As the client is not aware of those differences, he cannot identify where his own interests and those of the firm could possibly conflict.

In example 3 of a poor practice, by presenting the information in this way, the investment firm avoids distinguishing between in-house and third party products. It fails to provide clear information to its clients and is likely providing information that is potentially misleading.

Summary of findings

Documentation through which disclosures are made

118. There is a great variety of practices regarding documentation through which investment firms disclose in a summary form, payments (including non-monetary benefits) and no strong trends have been noticed in this area.

119. However, it appears that the following types of documentation are often used to disclose payments (including non-monetary benefits) made or received by investment firms :
- terms and conditions;
 - client agreement;
 - tariff sheet;
 - conflicts of interest policy;
 - product fact sheet;
 - "welcome information pack";
 - subscription order tickets.
120. In some situations, investment firms use a combination of the above mentioned documents to inform their clients (in summary or detailed form).
121. According to answers given by the investment firms surveyed, it appears that the type of documentation used to provide detailed information on request of the client is generally a letter or email sent to the client.

CESR's reactions regarding those findings and key issues

122. Article 26(b)(i) of the Level 2 Directive does not prescribe how the information should be provided. It however states that the information must be clear, comprehensive and understandable. It should also be fair, clear and not misleading²⁵.
123. In some situations, the summary or detailed information provided to the client is contained in a combination of documents which, together, can be considered as providing the required information to clients. This would especially be so when the information is provided through the general terms and conditions (where it is stated that the firm provides or receives third party payments and non-monetary benefits) and a product fact sheet (which contains a specific section on inducements, disclosing the existence, nature and amount or method of calculating the third party payment(s) received by the investment firm in connection with that product). Other firms disclose third party payments and non-monetary benefits via a combination of more than two documents (for example the general terms and conditions, the tariff sheet and product fact sheets).
124. CESR is of the opinion that the information must be provided for free in an easily accessible and in a user friendly format. The excessive use of cross-references or of different documents to inform the client does not meet the objective of Article 26(b)(i) of the Level 2 Directive. Also, as explained above in CESR's views of a summary disclosures, CESR believes that it is good practice to make disclosures in a durable medium within the meaning of Article 2(2) of the Level 2 Directive.
125. There is no one-size-fits-all approach regarding disclosures and CESR believes that when choosing the documentation through which disclosures are made, investment firms should take into account elements such as the type(s) of service(s) provided to their clients or the way they provide services to clients. For example:
- investment firms distributing a large number of financial instruments could decide to adopt a "two step approach" regarding disclosures: a summary disclosure to be provided to all clients in the initial client information pack, the general terms and conditions or the contract concluded with the client, and detailed disclosure to be provided to the client at the point of sale, through the product fact sheet given to the client before any transaction;

²⁵ Article 19(2) of MiFID and Article 27 of the MiFID Level 2 Directive.



- disclosures through the investment firm's website would be a natural way for online-brokers to inform their clients about third party payments and non-monetary benefits they provide or receive.

Question XIV: Do you agree with CESR's views on the documentation through which disclosures are made?

Good and poor practices - disclosure documentation

Good practices

Example 1: An investment firm which distributes financial instruments on-line through both advisory and non advisory services discloses on its website the existence and the nature of the third party payments it receives. It also explains in general terms what the amount of those third party payments can be, indicating that four situations can occur: the firm can receive nothing, up to 1/3 of the management fee, up to 2/3 of the management fee or more than 2/3 of the management fee in relation to different families of CIS distributed. Finally, not only does the firm very explicitly inform its clients of the opportunity to ask for further details (just by clicking on the same webpage), but the website also contains an inducements calculator, which enables the investor to calculate the amount of third party payment that the distributor will receive for any financial instrument the client would want to buy.

Example 2: An investment firm selling financial instruments solely on an execution only basis discloses third party payments it receives through the following two documents: its general terms and conditions and product fact-sheets. The terms and conditions inform the clients that the firm receives third party payments (with little or no additional information) and refer clients to product fact sheets for more information, while also stating that clients can request further details from the firm. The terms and conditions are provided to the client at the beginning of the relationship. The product fact sheets mention the exact percentage of third party payments that the firm receives and are provided to clients at the point of sale, prior to any transaction.

Comment

It is a good practice for investment firms to provide their clients with an inducements calculator, as in example 1, as this enables the clients to calculate, instrument by instrument, the amount of third party payments that the firm can receive. If adopted generally by investment firms, inducements calculators would also help clients to compare the practices of different firms. However, the use of an inducements calculator would not be sufficient to fulfil the requirements of Article 26(b)(i) of the Level 2 Directive. An appropriate summary disclosure should always be made next to such a calculator to provide clients with an overview of the situation as well as with other essential terms than the amount.

Example 2 provides an illustration of a situation where it seems reasonable to make disclosures to clients by using two different documents, in so far as the product fact sheets are automatically provided to the client, in order to enable the client to make informed decisions. The same approach does not appear to be suitable for situations where other types of services are provided. For example, when investment advice is provided, one may consider that summary disclosure should be made through the general terms and conditions or other disclosure document provided to the client prior to the provision of the service. This would indeed enable the client to have a global view of the situation and thus to be better aware of the instruments that the investment firm may have an interest in encouraging him to buy.

Poor practices

Example 1: In order to disclose summary information about third party payments it receives, an investment firm that distributes financial instruments uses a combination of media. Specifically, the information is split between various documents: general terms and conditions (where the firm indicates that it receives third party payments), tariff sheet (where the firm uses bands to disclose third party payments received) and product fact sheets (where, for some products, the maximum percentage of the rebates it receives is given).

Example 2: An investment firm, whose main distribution channel is physical offices, discloses in a special section of its “welcome information” brochure that the third party payments and non-monetary benefits received from product providers are available on its corporate web site.

Comment

Example 1 of a poor practice provides an illustration of a situation where the use of various documents does not facilitate the clients’ understanding of the issues at stake. Although the combination of a general document (such as the firm’s terms and conditions) and a specific document (such as an appropriately drafted product fact sheet) can, in some circumstances, be regarded as fulfilling the disclosure requirements defined in Article 26(b)(i) of the Level 2 Directive, sending a client from one document to another is unlikely to be considered a fair and clear way to inform clients. Furthermore, in such a situation, the client will not be able to have an overview of the situation and therefore may not be in a position to make an investment decision.

As the summary disclosure in example 2 of poor practice states that the disclosure is only available on the web page, the investment firm fails to provide the information in an easily accessible format to its clients, as the firm’s clients typically go to the firm’s offices to contract the firm’s services and some of them may not have access to the internet. Therefore, the firm cannot ensure that information about third party payments and non-monetary benefits is provided prior to the provision of the service as required under Article 26(b)(i) of the Level 2 Directive.

Summary of findings

Feedback from clients about disclosures

126. Very few investment firms have received feedback from clients about the inducements disclosures they make. The main feedback received is as follows:
- a minority of clients asked for more detailed information, after having received a summary disclosure of payments and non-monetary benefits provided or received;
 - a minority of clients considered that the summary information received was confusing or unnecessary (this last type of feedback was received from high net worth individuals to whom private banking and/or wealth management services were offered).

CESR’s reactions regarding those findings and key issues

127. The reason why little feedback, including requests for more detailed disclosures, has been received is unclear. So, it is currently difficult to draw any conclusion from this about whether or not clients find the information in disclosures to be of use. It also appears that not all investment firms have informed clients, in the summary disclosure, of their right to request further details. This emphasises the importance of an appropriate summary disclosure to clients.

Good and poor practices - Feedback from clients

Good practices



Example 1: An investment firm providing a wide range of services and financial instruments to a wide range of clients:

- informs its clients of their right to request (and receive) further details about third party payments and non-monetary benefits) provided and received and informs them to whom they can make their requests;
- has adopted specific arrangements and procedures to ensure a prompt and appropriate treatment of such requests.

Comment

In this example, the organisational measures adopted by the investment firm should enable it to fulfil its obligations under Article 26(b)(i) of the Level 2 Directive.

Summary of findings

Difference of treatment between retail and professional clients

128. It is only in exceptional circumstances that investment firms make different disclosures depending on the category of the client. Such differences commonly concern the level of detail of the information provided: retail clients benefit from more detailed information on payments and non-monetary benefits.

CESR's reactions regarding those findings and key issues

129. According to Article 26(b) of the Level 2 Directive, the disclosure requirements apply equally to all categories of clients. However, what constitutes a fair, clear and not misleading disclosure can vary between retail and professional clients. Professional clients have the knowledge and experience to make their own investment decisions. It is legitimate for investment firms to take this into account in the drafting of summary and detailed disclosures under the MiFID inducements rules.

Question XV: Do you agree with CESR's views on the difference of treatment between retail and professional clients?

VII. Experience of firms' cross border implementation

Summary of findings

How many firms are affected?

130. Investment firms in a minority of Member States have not reported about their experience of cross border implementation as the firms responding to the questionnaire in these Member States had no cross-border activity.

131. In a majority of Member States firms with cross-border activities were selected to respond to the questionnaire. The proportion of investment firms with a cross-border activity in relation to the total number of selected firms that have responded, varies considerably. Depending on the size of the sample taken by each CESR member, this question was often answered by one or two firms per Member State at maximum.

132. The majority of investment firms did not have to adopt any different arrangements and procedures across the Member States concerned to comply with Article 26 of the

Level 2 Directive. Of all firms taken together, a small minority of firms reported that they had to make changes to comply with Article 26 of the Level 2 Directive.

133. Mostly internationally active groups operating several subsidiaries across Europe seem to have been affected. These investment firms tend to develop a uniform group approach. In one case the group approach has been based on the UK rules, supplementing and amending them where necessary. In general the existing differences between Member States' implementations do not seem to have led to significant barriers to cross-border activity. However, one firm with significant cross-border operations said that the line taken on an acceptable summary disclosure, types of payment and remuneration structures, differs between EEA Member States making it difficult to achieve a convergent application of the MiFID inducements rules, without going into further detail.

Specific examples

134. Concerning a situation that now belongs to the past, a minority of investment firms mentioned that their cross-border activities had been made difficult where Member States had been late in implementing MiFID.
135. In addition, some investment firms noted the competitive disadvantage of EEA investment firms with regard to the inducement disclosure requirements when dealing with a non-European client, as compared to firms based in a non-MiFID jurisdiction, and considered whether some flexibility was required to facilitate competition.
136. In addition, some regulators have themselves reported about specific rules influencing the application of the MiFID inducements rules. The UK FSA, for example, has recently proposed rules which would allow investment firms providing investment advice to continue to be paid by a rebate from the commission the client pays to a product provider but prevent the product provider from setting the amount of the rebate (which would have to be agreed between the client and the adviser). At least two other Member States have rules which limit the payments that investment firms providing portfolio management services can receive from firms executing client orders.

Trends

137. In general the existing differences between Member States' implementations do not seem to have led to significant barriers to cross-border activity. However, the situations described show that there are areas where improvement is desirable. Above all, this will involve a better understanding by investment firms of the application of the MiFID inducements rules.



ANNEX I- Article 26 of the MiFID implementing Directive (“Level 2 Directive)

CHAPTER III

OPERATING CONDITIONS FOR INVESTMENT FIRMS

Section 1

Inducements

Article 26

(Article 19(1) of Directive 2004/39/EC) Inducements

Member States shall ensure that investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or ancillary service to the client, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) a fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;

(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service;

(ii)

(ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client;

(c) proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

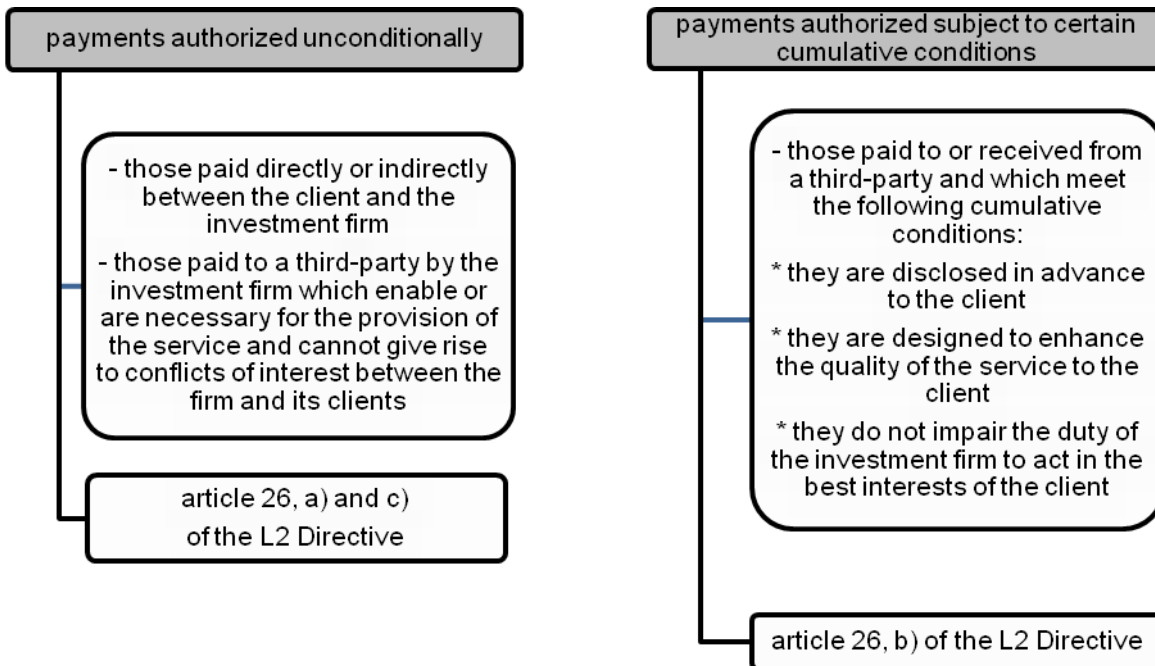
Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking.



ANNEX II- CESR Inducements Questionnaire

MiFID²⁶ introduced new rules regarding fees, commissions or non-monetary benefits (hereinafter "payments (including non-monetary benefits)") that investment firms may pay or receive, provide or be provided, in relation to the provision of investment or ancillary services to clients.

The rules distinguish between two categories of payments (including non-monetary benefits) which investment firms are permitted to make or receive which are set out schematically as follows:



The aim of this questionnaire is to have a better insight into the manner in which firms apply the new rules. In this respect, each regulator has selected a series of firms under its supervision that it considers representative for the purpose of the survey. Your firm is amongst those selected. Your supervisor may decide to undertake visits to follow-up on your responses to the questionnaire and will collate the results of this exercise in its jurisdiction. In a second step of this exercise CESR will discuss and elaborate a paper that will be made public in Q2/Q3 2009 containing the regulators conclusions on the exercise and seeking to identify industry good practices and areas for improvement regarding inducements. No reference to particular firms will be made in the CESR paper.

For the questions which require a more elaborate answer than simply "yes" or "no", we request your firm to provide information in a separate document making reference to the number of the question. If the answer varies according to the type of investment or ancillary service concerned and/or the type of financial instrument concerned, please make the necessary distinctions.

Please complete the enclosed questionnaire and send it back by xx / xx / 2008 to:
[name of regulator
c/o
address]

1. Classifying payments (including non-monetary benefits) and setting up an organisation to be compliant

²⁶ Article 26 of the L2 implementing Directive (which in part implements Article 19(1) of the MiFID L1 Directive).

1.1.	What arrangements and procedures has your firm set up to classify the third party payments (including non-monetary benefits) ²⁷ it makes or receives in relation to the provision of investment/ancillary services?	
1.2.	What arrangements and procedures has your firm set up to ensure that the third party payments (including non-monetary benefits) it makes and/or receives in relation to the provision of investment or ancillary services - including intra-group payments (including non-monetary benefits) - comply with the MiFID inducements rules?	
1.3.	Did these arrangements and procedures have an impact on your firm's previous practices regarding payments (including non-monetary benefits)? If so, please specify how. For example, has your firm stopped making/receiving any third-party payments (including non-monetary benefits) as a result of the MiFID inducements rules?	
1.4.	Payments (including non-monetary benefits) that fall in the category of proper fees include custody costs, settlement, exchange fees, regulatory levies and legal fees. Can you list any other payment that your firm classifies within the category of proper fees?	

2. Payments (including non-monetary benefits) authorised subject to certain cumulative conditions - acting for the best interests of the client and designed to enhance the quality of the service provided to the client

2.1.	Please provide us with a list of the types of third-party payments (including non-monetary benefits) your firm makes or receives in relation to the provision of an investment service.	
2.2.	In relation to the investment service your firm provides: <ul style="list-style-type: none"> - How does your firm assess the risk that conflicts could arise as a result of making or receiving payments (including non-monetary benefits) to or from third parties? - How does your firm ensure that any risks are managed so that the payments (including non-monetary benefits) do not conflict with the duty owed to the client? - In which situations or for which reasons does your firm consider that third-party payments (including non-monetary benefits) it makes or receives are designed 	

²⁷ Payments (including non-monetary benefits) between the firm and a third party (not the firm's clients). It includes intra-group payments (including non-monetary benefits) as well as non-monetary benefits.

	to enhance the quality of the service provided?	
2.3	On average, what proportion of your revenue in respect of the provision of investment services is made of third-party payments (including non-monetary benefits)?	

3. Payments (including non-monetary benefits) authorised subject to certain cumulative conditions - disclosure

3.1.	Does your firm disclose payments (including non-monetary benefits) to/from third parties and other non-monetary benefits to clients in a summary form? If so, please attach an example of a summary disclosure to your clients.	yes		no	
3.2.	Does your firm disclose payments (including non-monetary benefits) to/from third parties and other non-monetary benefits to clients in a detailed form? If so, please attach an example of a detailed disclosure to your clients.	yes		no	
3.3.	Would your disclosure on third-party payments (including non-monetary benefits) ever include any of the following ²⁸ :				
	– Bands (e.g. x to y %)?	yes		no	
	– Maximum levels (e.g. y %)?	yes		no	
	– Specific amount (e.g. x euros)?	yes		no	

4. Experience of Member State implementation

4.1	Do you find that the rules transposing the MiFID inducements requirements are different between Member States? Please provide us with specific examples.	
4.2	Are you finding differences between Member States in the application by regulators of the MiFID inducements requirements? Please provide us with specific examples.	

This questionnaire was prepared by the CESR MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Management Committee of the CBFA, and by its sub-Group on Intermediaries, chaired by Mrs María José Gómez Yubero, Director at the CNMV. For more information on this document or on CESR activities regarding intermediaries, please contact Diego Escanero at descanero@cesr.eu.

²⁸ If applicable, please make a distinction between the information provided in the summary and detailed disclosure.



The contents are merely illustrative and do not constitute legal advice. The MiFID legal texts are available at http://ec.europa.eu/internal_market/securities/isd/index_en.htm

ANNEX III – Relevant CESR inducements documents

CESR Level 3 Recommendations on the List of minimum records in article 51(3) of the MiFID implementing Directive, Feedback Statement (CESR/07-085), February 2007
www.cesr-eu.org/data/document/07_085.pdf

Inducements under MiFID, Recommendations, (CESR/07-228b), May 2007
http://www.cesr-eu.org/index.php?page=document_details&id=4608&from_id=53

Inducements under MiFID, Recommendations, second consultation paper (CESR/07-228), April 2007
<http://www.cesr-eu.org/popup2.php?id=4473>

Inducements under MiFID, Public consultation (CESR/06-687), December 2006
<http://www.cesr-eu.org/popup2.php?id=4085>