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VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Mr Carlo Comporti
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CESR Consultation Paper “Inducements: Good and poor practices”
Ref.: CESR/09-958

Dear Mr Comporti,

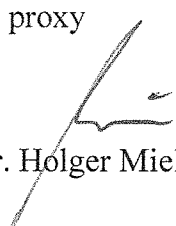
thank you very much for the opportunity to comment on CESR’s Consultation Paper “Inducements: Good and poor practices”. Please find enclosed our comments. If you have any questions please do not hesitate to contact us.

Yours sincerely,
on behalf of the

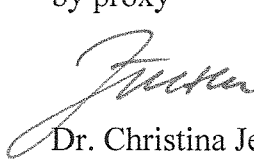
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Bundesverband der Deutschen
Volkbanken und Raiffeisenbanken e.V.

by proxy


Dr. Holger Mielk

by proxy


Dr. Christina Jensen

Enclosure

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Comments of the Zentraler Kreditausschuss¹ on the CESR Consultation Paper “Inducements: Good and poor practices”

Ref.: CESR/09-958

22nd December 2009

¹ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

I. General comments

The Zentraler Kreditausschuss (ZKA) welcomes CESR's initiative regarding consultation on 'good and poor practices' in conjunction with the application of the rules on inducements specified in article 19 (1) of MiFID and article 26 of the MiFID Level 2 Directive.

Particularly when one considers the way in which these rules are implemented and applied by the relevant market participants in Germany, they have proven to be highly effective in ensuring that investment firms, when providing investment services and/or ancillary services, act honestly, fairly and professionally in accordance with the best interests of their clients.

The regulatory approach in this area must provide an adequate balance between two objectives, namely the provision of an adequate level of protection for (mainly retail) investors and making such provision practicable and proportionally appropriate.

Furthermore, CESR should make clear that its statements do not create European Union legislation, but that the statements are only explanatory and can be applied only in the interpretation of the legal text. Likewise, it should be made clear that the description of a particular practice as 'poor practice' cannot be deemed per se an indicator of a violation of the MiFID Inducement requirements. Otherwise the statements made by CESR would have an effect similar to that of law.

II. Specific comments

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

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

We agree with CESR's view that arrangements and procedures are essential in fulfilling investment firms' obligations under the MiFID inducement rules.

The examples given of 'good practices' reflect to a substantial degree the current market practices in Germany.

We agree with CESR's position that investment firms enjoy a certain degree of flexibility in the approach to be adopted according to the nature, scale and complexity of their business (section 29). This concept is also reflected in German law by section 33, paragraph 1, sentence 3 of the German Securities Trading Act (Wertpapierhandelsgesetz [WpHG]).

Thus, with a view to the feasibility for everyday use of the requirements, we welcome in particular the clarification that it is sufficient when types of payments and non-monetary benefits are reported (see section 34 on page 11 as well as the first CESR comment on page 13). From this point of view, in our understanding the comment on example 1 of the 'poor practices' (page 13) regarding the subtitle 'Good and poor practices – classification of payments and non-monetary benefits' is to be interpreted as follows: the objective of reporting all relevant payments and non-monetary benefits can also be accomplished by listing the types of relevant business transactions. Furthermore, this clarification should also be made by CESR with a view to the comments on 'evaluation'. For details, see also our comments regarding question III.

We agree with CESR that the requirements of article 26 of the level 2 directive must be met before any payment or benefit takes place (section 34). However, we request clarification that this exercise does not have to be undertaken by the compliance function. In other places CESR itself assumes that 'multidisciplinary teams' (section 20) and 'internal units responsible for inducements compliance' (see 'Good and poor practices - identification of payments and non-monetary benefits, example 1, page 12) can undertake such an exercise.

The question of competence for the fulfilment of the requirements of article 26 of the level 2 directive remains unaffected by the fact that the compliance function has to advise and assist the relevant persons responsible to comply with the above mentioned requirements as well as to monitor and regularly assess the adequacy and effectiveness of the measures and procedures put in place (see also art. 6, paragraph 2, lit. (a) and (b) of the level 2 directive).

Contrary to CESR's position set forth in section 35 of the consultation paper, we consider it an unnecessary formality to perform a standardised periodic review of recurring payments/non-monetary benefits without any concrete reason. Such reviews and reassessments should be required only in the case of material changes in the terms of or the circumstances surrounding such payments/non-monetary benefits. The same applies to the CESR comments under 'Good and poor practices – identification of payments and non-monetary benefits' (p. 13). 'Existing products' do not require a new review if there is no specific reason for one.

On page 14 below (example 1 under 'Good and poor practices – record keeping'), CESR states that good practice is when investment firms maintain facilities 'to record and track every relevant action'. We consider it to be excessive to monitor and to document every single transaction in accordance with article 26 (a) and article 26 (c). Such comprehensive documentation would be extremely complex and not very appropriate to everyday practice. CESR also assumes that payments by third parties are generally subject to the scope of application of article 26. Assumed, this would be the case, the question is which payments are still outside of the scope of application of article 26 (see sections 53 and 57, for example). Rather, it should be clear that payments for services provided which are not connected with the sale of a financial product are not covered by the scope of application of article 26. This must apply particularly to in-group payments as well, as it cannot make a difference whether an in-group company performs a service and receives a fee for it which is not to be classified as an inducement, or an external company. Without further clarification, there is a risk of creating legal uncertainty. In this context, it should be highlighted more clearly that the listing under section 43 is a list of 'proper fees'.

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?

We agree with CESR that the monitoring and regular assessment of the adequacy and effectiveness of the measures and procedures for complying with the requirements of article 26 of the level 2 directive is a duty of the compliance function (section 37).

The assessment by the compliance function does not have to be done 'on an ongoing basis', but only 'on a regular basis' (see also article 6, paragraph 2, lit. (a) of the level 2 directive). We therefore suggest changing the text in section 38 accordingly.

With respect to guidelines on the interpretation and scope of such rules, the overarching principle of a uniform regulatory approach should apply.

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?

We agree with CESR that the 'senior management' must approve the principles of compliance with the requirements for payments and non-monetary benefits. This is necessary, but also sufficient.

Against this background, section 37 should be written more clearly and the words 'at least' should be deleted. The same applies accordingly to example 1 in 'Good and poor practices – the role of senior management and the compliance function', p. 15.

Moreover, we wish to make several comments on the following 'good and poor practices' listed below:

Good and poor practices

- **Identification of payments and non-monetary benefits**

See our comments regarding question I about section 35.

- **Classification of payments and non-monetary benefits**

We suggest that the words 'compliance officer' in the last sentence of the CESR comments should be replaced by the words 'compliance function'.

Furthermore, we wish to refer to the welcome clarification under question I that it suffices when types of payments and non-monetary benefits are documented and classified (see section 34 and the first comment on p. 13 above). We suggest that this should be linguistically expressed in the examples as well, by supplementing the phrase 'relevant payments and non-monetary benefits' with the phrase '...or types of payments and non-monetary benefits'. Purely as a precautionary measure we wish to note that a deviating interpretation which would result in a classification of each individual case of a payment or a non-monetary benefit would be disproportionately complex and would be of no practical use, as the result of the classification within the respective types is the same for all cases covered thereunder.

- **Evaluation of payments and non-monetary benefits**

With reference to example 1 of the 'poor practices' on page 13 ff. we wish to refer to the welcome clarification under question I that it suffices when types of payments and non-monetary benefits are documented and classified. Consequently, the examples provided for the topic of evaluation should in our view also be interpreted in a manner that it suffices to make the assessments for the relevant types. We therefore suggest that this likewise should be linguistically expressed by supplementing the phrase 'relevant payments and non-monetary benefits' with the phrase '...or types of payments and non-monetary benefits'. Purely as a precautionary measure we wish to note that a deviating interpretation which would result in an evaluation of each individual case of a payment or a non-monetary benefit would be disproportionately complex and would be of no practical use, as the result of the evaluation within the respective types is the same for all cases covered thereunder.

- **Role of senior management and the compliance function**

See our comments regarding question III about section 37.

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)?

We agree with CESR's view. Without payment of these fees an order cannot be executed at a certain venue and we see no reason why such fees should impact the interest of the client. Besides, the investment firm must already evaluate the fees charged by an execution venue under the best execution rules set forth in Art 21 MiFID and Art 44 of the Level 2 Directive.

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?

We agree with CESR's view. In particular, certain types of custody-related fees such as fees paid by the investment firm in connection with specific corporate events such as shareholders' meetings, dividend distributions, etc., and items such as payments to information service providers or consultants for the provision of investment-related services can be eligible for the proper fees regime. In many instances, the failure to pay such fees would prejudice the client's rights in connection with his investment and therefore, such fees have to be eligible under 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?

No comments.

Payments and non-monetary benefits authorized 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?

On this point, we explicitly disagree with CESR's position. The level of risk that an investment firm will not act in the best interest of the client, which would be a violation of MiFID rules, does not depend on its general fee structure (up-front fee vs. ongoing payments) but rather on whether the fees charged by the investment firm in a specific case

comply with the criteria set forth in article 26 of the level 2 directive. Therefore, the general statement or implication that a fee structure which is (at least partially) based on ongoing payments always bears more risk for the investor than a fee structure solely based on one-off-payments is incorrect, misleading and not supported by empirical data.

A fee structure that is to a significant extent based on ongoing payments may in particular be beneficial for investors who have limited funds to invest. Since this group of investors, especially in markets where such fee schemes are well established, will generally be unable and/or unwilling to pay a high direct up-front fee for investment advice, fees based on ongoing payments, that are in effect paid out of revenue generated by the investment itself, will provide them with the possibility of receiving quality investment advice and making suitable investments. This position is clearly supported by the fact that in market segments for investment products that are directly targeted at small investors, such as the German tax-incentivized private pension scheme ("Riester Rente"), approximately 90% of the eligible investors have actually invested in the respective products. At least to some degree, this level of market penetration is certainly attributable to a fee structure that does not burden the investor with high up-front investment advisory fees.

Also, the total amount of fees based on ongoing payments that is charged to an investor during the term of his investment is not necessarily higher than one-off fees since its calculation is based on the average (and recommended) term of an investment in the respective product.

Finally, an investment firm that receives part of its fees based on ongoing payments has no incentive to churn the portfolio of the investor in order to receive additional up-front fees but is rather incentivized to build a long-term, loyal relationship with its client, since a significant portion of its fees will only be received over time and based on the performance of the portfolio and hence on investor satisfaction. Therefore, such a fee system generally has a stabilizing effect on the markets. The assumption that ongoing payments are more lucrative cannot be approved.

Many financial products are generally purchased with a long-term investment horizon. If the investor is informed of this type of payment and accepts it, he has made an informed decision. Consequently, the risk compared to one-off payments is not higher. The fees paid up front are no longer available for the investment and thus play no role in any value development in favour of the client. In contrast to this, the ongoing fee elements are only successively withdrawn from the investment volume invested for the investor, so that

these amounts can play a role in the value development, at least until the point of withdrawal.

In view of these facts, a general statement to the effect that fee schemes based on ongoing payments received over a period of time bear a greater inherent risk that the investment firm is not acting in the best interest of the client is certainly incorrect. It is, therefore, not justified to discredit certain well-established market structures which have proven to be highly effective and particularly beneficial for small retail investors without looking at each single case and applying the criteria of the MiFID inducement rules.

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?

As already stated in our comments on question II, we agree with CESR that the monitoring and regular assessment of the adequacy and effectiveness of the measures and procedures for complying with the requirements of article 26 of the level 2 directive is a duty of the compliance function.

Keeping in mind the requirement that 'the payment ... must not impair compliance with the firm's duty to act in the best interests of the client', this means that the compliance function must monitor and regularly assess whether in the case of an investment advice, the requirements of the suitability test are complied with despite inducements. Additionally, the compliance function must take into account client complaints by its monitoring and assessment. In our opinion, these measures are necessary, but also sufficient.

Insofar as the CESR paper gives the impression that compliance with the requirements of the suitability test is not sufficient to fulfil the above-mentioned requirement (to this extent unclear in section 78; see also example 3 and comments on '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', p. 25 ff.), this is to be rejected as too extensive. It is not clear what type of 'additional steps' are meant by CESR and of which nature they could be. In our opinion, the reference to the fee-based consultation is not a suitable solution in any case (see our comments on question X below). The principle of proportionality should always be maintained.

The question of a conflict of interest arising from the reward of the investment firms' advisers and sales staff (see example 4 and comments on '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', p. 25 f.) plays no role in the requirements of article 26 of the level 2 directive, but exclusively in the general requirements of the management of conflicts of interest (see article 21, lit. (b) of the level 2 directive). Article 26 of the level 2 directive specifies only that the payments or non-monetary benefits that the investment firm itself receives must 'not impair compliance with the firm's duty to act in the best interests of the client'. We therefore request that no comments should be made on the reward of advisers and sales staff in the planned paper on inducements.

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?

Although we recognise that payments or non-monetary benefits received by investment firms may give rise to potential conflicts of interest, such fees in many instances facilitate access to the product or provide better knowledge and information about the product and are therefore designed to enhance the quality of the service. We do not see that such a fee structure is generally more risky for the client than other fee structures and the MiFID provides various mechanisms to deal with conflicts of interests in the cases in which they actually occur.

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?

We agree that the fact that a fee would otherwise have to be paid by the client is in itself not sufficient to determine whether such a payment is designed to enhance the quality of the service. However, recital 39 of the level 2 directive shows that the European legislator takes a generally positive approach towards such payments, as long as the investment firm's advice is not biased as a result of the receipt of such commission. Therefore, it is not justified to label such fee structures in general as 'potentially bad and dangerous for clients', as long as the advice is not biased and the requirement is met.

We also do not agree with CESR's view that cost savings for the client do not contribute to improving the quality of service. Such a narrow interpretation of the stipulation 'designed to enhance' will lead to this criterion being useless. As the range of additional and higher-quality services is inseparably linked to cost savings for the client, this narrow interpretation would lead to a deterioration in the range of services offered.

The argument that this exception is not relevant in the context of asset management or a higher standard must be applied for justification, cannot be approved either. Even in the context of asset management, the client receives comprehensive information about any inducements before signing the corresponding asset management contract. He thus makes an informed decision and accepts these payments up front. It is not clear, why the exception 'designed to enhance' should not apply here.

We explicitly disagree with CESR's comment that *'an investment firm could avoid this conflict by charging directly for investment advice'*. In our view the general fee structure (indirect payments vs. direct upfront charges to the client) is risk-neutral with respect to potential conflicts of interest. Such conflicts of interest can arise in both fee structures and must be dealt with using the various mechanisms provided and required under the MiFID rules, but not by generally favouring one specific fee structure, in particular since such fee structure may have other disadvantages for clients. Thus, in the case of a direct payment by the client for advice, there is a risk that the provider could generate an artificial need for advice on the part of the client in increasingly shorter intervals with targeted information and thus carries out churning at the level of advisory services. Indirect payment thus merely replaces one type of conflict of interest with another.

As outlined in our response to question VII, there are circumstances as well as market structures and segments where a structure with payments and/or non-monetary benefits from product providers is the only possibility for large groups of investors, mainly retail investors with limited funds to invest, to have access to quality investment advice. These clients would not be willing or able to pay an adequate direct charge for investment advice over a very broad range of investment products and, therefore, in these circumstances payments and/or non-monetary benefits are clearly designed to enhance the quality of the investment advice.

We therefore strictly oppose the attempt to classify certain fee schemes as 'good practice' or 'poor practice' on a general basis. Any other approach would be inconsistent with recital 39 of the level 2 directive that sees indirect payments to investment firms as generally

legitimate. For this reason, we do not see example 3 on page 25 necessarily as poor practice. The question whether the advice is biased because of the rebate must be evaluated in each individual case using the suitability test.

We explicitly disagree with the view of CESR, illustrated by examples 2 and 3 on page 25, that discounts (the investment firm buys the products from the distributors at a discount to the amount charged to its clients) are to be classified as inducements in the form of indirect payments. Article 26 of the MiFID level 2 directive explicitly mentions only payments by third parties: '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**...'. This is also confirmed by the CESR Recommendations on Inducements, p. 7, Recommendation No. 2, No. 11, which explicitly includes only third-party payments in the scope of application. Third parties are all persons or companies outside of the relationship between the investment firm and clients using its services. However, the difference between the purchase price and sale price arises exclusively in the relationship between the client and the bank, and thus is not a payment from third parties. If this was viewed differently, it would clearly contradict the unambiguous text of the European legislation. With regard to the intention and purpose of Article 26 of the level 2 directive as well, the inclusion of discounts in the scope of application of the requirements cannot be meant, as otherwise a limitless expansion to every form of realisation of profits of the investment firms would result. This would also include those, which are protected by trade secrets. Any interest in profits of the investment firms would be subject in principle to prohibition pursuant to article 26 b of the level 2 directive, regardless the fact that the investment firms are economic enterprises operating in the market. The same applies accordingly with regard to the passages in sections 63 and 66.

Payments and non-monetary benefits authorized 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)?

German investment firms already have to follow such procedures under the applicable provisions of German law. We would like to emphasise that it must be ensured that the existing rules are practicable and proportional.

We consider the statements of CESR in sections 96 ff., particularly in sections 98 (from the second to the last sub-paragraphs), 100, 101, 116, 117 and 124 to go too far.

According to domestic law, the banks are not obligated to offer third-party products or the most affordable product with regard to costs or to produce corresponding market comparisons related to sales remunerations and other costs. Thus there is no reason to orient the type and scope of the disclosure obligation for inducements to these criteria. The extension to *in-house* as opposed to *in-group* products in this context also appears to go quite far (see in particular section 96 and section 98, from the second to the last sub-paragraphs.). Altogether the requirements go into too much detail or are far removed from everyday practice (see the end of section 100, for example, the requirement that 'an estimate of the value of the investment research' should be given).

The reference to article 27 of the level 2 directive, which contains very detailed and largely inappropriate requirements tailored to other applications, also goes too far. In our opinion, a reference to article 27 of the level 2 directive would lead to considerable uncertainty during implementation in practice, without producing any benefit for clients. In this context, the general requirement in article 19 (2) MiFID, according to which the information must be 'fair, clear and not misleading' is definitive and sufficient.

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

See our comments regarding question XI.

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

The use of bands in an investment firm's disclosure should be permissible and, in particular in the summary disclosure, is necessary.

The CESR requirement of the disclosure of a minimum level of third party payments in the case of the reporting of bands (see sections 116 and 117) is not convincing. According to domestic law, the banks are not obligated to offer third-party products or the most affordable product with regard to costs or to produce corresponding market comparisons related to sales remunerations and other costs. Thus there is no reason to orient the type and scope of the disclosure obligation for inducements to these criteria. The starting point for the disclosure obligation is the avoidance of any conflict of interest which otherwise

would not be apparent to the client. Such a conflict of interest is sufficiently avoided by informing the client of the possible maximum inducements. It does not appear likely that a client would make a different investment decision based only on the fact that he was informed of the maximum rate only but not also the minimum rate (compared to his hypothetical decision in the case that he had also been informed of the minimum rate). Instead, the information on the product information sheets, supplemented by further details such as these, would become increasingly complex and incomprehensible and would make it more difficult for the client to filter for criteria which in his personal opinion were important to his investment decision. The minimal potential benefit to the customer is offset by the immense effort and expense which would be required of the institutes to subject not only the maximum rate but also the minimum rate in their product information to the necessary monitoring and to eliminate possible sources of error among the numerous and varied products offered to the client.

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

In section 125 we request clarification that a 'detailed disclosure' is not compulsory, but required only upon request of the client, if the latter has already received a 'summary disclosure', combined with the offer of further information upon request.

In example 1 on page 37, an 'inducement calculator' is described as being good practice. Currently we are not aware that such a calculator is offered to clients in Germany. If the client knows the percentage rates for sales fees before signing the contract, he can calculate the amounts without further ado. Against this background, an 'inducement calculator' for clients represents a possible additional technical aid, but does not provide any additional information. Such a requirement cannot be derived from the statutory provisions and would be disproportional.

Moreover, the following must be taken into account: The amount of the actually incurred sales fees depends on a wide variety of factors. For instance, in the case of ongoing trail commissions these are, for example, on the invoicing mode with regard to the relevant security (monthly, quarterly, etc.), on the reference date of the calculation in accordance with the sales agreement and the value applicable at that time (e.g. share value). In addition, the client must hold the relevant security in his deposit on the reference date. No additional information is sent to the client about the invoicing reference dates. As the client

can request information about the specific amount of the sales fees incurred at any time, in our opinion this should not have to be provided.

Furthermore, in our opinion, the statements in example 1 on page 38 are unconvincing; according to these, CESR deems it poor practice when statements on payments or non-monetary benefits are distributed among various documents (general reference in the account opening documents, bandwidths in the fee schedule and statement of the maximum percentages received in the product information). We would advocate deletion of the example. According to MiFID, before the provision of investment services or ancillary services, the client must first be informed about payments or non-monetary benefits in accordance with article 26 of the level 2 directive and must be provided with a description of the conflict of interest policy of the investment firm in accordance with article 30, paragraph 1, lit. (h). Upon request, the client must also be informed of the specific amount of the payments and non-monetary benefits. The problems described do not arise from the combination of various information provided to the client, but rather from the fact that various documents might not be sufficiently coordinated or that an individual document may not contain sufficient information. Thus, in its comments CESR itself comes to the conclusion that information provided by the presentation of multiple documents does not violate the MiFID requirements per se. The example of a 'poor practice' could thus be likely to produce uncertainty regarding to a statutory and legally required procedure.

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

We agree with that a distinction should be made between retail and professional clients in determining what constitutes fair, clear and not misleading disclosure inducements. This distinction is allowed under MiFID in several areas and is therefore in line with the general regulatory approach.
