

ABI reply to
CESR consultation about
“Inducements under MiFID”
(ref: CESR/06-687)

February 9 2007

The Italian Banking Association (ABI, “Associazione Bancaria Italiana”) appreciates the opportunity it is given for expressing its opinion about the consultation procedure implemented by CESR (Committee of European Securities Regulators) in relation to the rules on *inducements* defined by MiFID (Markets in Financial Instruments Directive).

General considerations

1. ABI agrees on the necessity to identifying a common approach in the application of the rules on *inducements* defined by the Level 2 MiFID. This is an important issue that needs to be analyzed also taking into account the indications provided by the financial operators.
2. In our opinion the approach of the consultation document goes behind the purposes of the rules on inducements defined by the MiFID, because they include a range of compensations that is too broad.
3. The CESR document, in fact, is limited to a literal interpretation of Art. 26 of the Level 2 Directive and it does not take into account the differences among payment for services and *inducements*.
4. In fact we need to remember that Art. 26 of the Level 2 Directive is meant to implement the principles set forth in Art. 19 of the Level 1 Directive, and in particular is meant to implement the provision set forth in Paragraph 1, that demands the intermediary banks to act in a honest, fair and professional matter in order to act in the best interests of the client. We would also like to point out that the term “*inducements*” evokes forms of payment potentially capable of inducing the firm to act in a dishonest, unfair and unprofessional manner: therefore this form of payment does not belong to the standard payment procedures (made according to market procedures) for services provided by the banks to their clients.
5. Not by accident the term “*inducements*” is used in the Directive only:
 - In point 40, where it states that the Directive “allows” the investment firms to provide or receive some incentives but only at certain conditions, and provided they are disclosed to the clients, or are given to/from the client to/from a person acting on behalf of the client. Therefore these incentives can be cashed only under certain circumstances, while, logically, valuable considerations charged to a client for the performance of a service cannot be subject to any condition that would allow them to be cashed;
 - In Art. 21, Letter e), where it takes into account only the incentives received/paid by the firms to/from third parties, that are different from the amounts normally invoiced for services performed for the client, the notion of incentive is introduced. This reinforces the concept that incentives are compensations that are different from the valuable considerations normally

invoiced for services provided to the clients and it clarifies that incentives presume the existence of a risk of conflict of interests;

- In the heading of Art 26 as well as in the formulation of the provisions set forth in it.
6. Even before a legal point of view, the CESR approach and in particular what is proposed in the examples made in reference to the mutual funds, cannot be agreed upon from a material and economic point of view, because it ignores the circumstance that the commissions paid by the managing firms to the brokers constitute the payment for services provided by the distribution network that are fundamental for the mutual funds.
 7. In fact, we need to point out that mutual funds are established and managed by firms that are specialized in the financial management of investments and they have several underwriters and investors. Their success is based upon their ability to offer diversified investment services that are highly qualified and cost competitive and therefore attractive also for clients with limited investment capabilities.
 8. In order to be efficient, mutual funds need to manage large funds. This implies a very large number of underwriters and investors for each common fund, besides, obviously, the ability of the managing firms to best invest the assets of the mutual funds in order to increase their equity value.
 9. To obtain many underwriters for their mutual funds the managing firms need a widespread and large distribution network that is capable of reaching investors in order to gain the initial share subscriptions and to perform further operations (such as fund transfers, further subscriptions, redemptions, and dividend distributions).
 10. Establishing, organizing, controlling and managing their own distribution network would mean facing excessive fixed expenses in order to guarantee the efficiency of the mutual funds industry. This explains why all the management firms decided to use an external distribution network: in this way, the management firms, besides designing different types of funds to offer the market, can focus more on their “core” business which is the financial management of mutual funds.
 11. All the above underline that the distribution network is an integral aspect of the value creation chain of the mutual funds industry. This network is made of two activities: the first one is involved in product creation and it belongs to the management firms, the second one is involved in distribution and it belongs to the brokers.
 12. The compensation for the activities performed by the managing firms in the management of mutual funds are divided in the following types of commission:
 - a. Underwriting and redemption commissions, paid by the investor at the time of the investment or at the time of the redemption. These commissions are very low, almost nonexistent. This approach offers an advantage for the client that does not have to pay high initial (nor

closing) commissions, that could affect future decision of disinvestment;

- b. The managing commissions charged daily to the mutual funds assets that reduce the daily value of the fund shares owned by the investors. This mechanism allows applying the pro-rata costs of the mutual funds to the daily share value, including the costs intended to pay the distribution network and therefore this mechanism allows to “spread” over time the incidence of these costs over the value of the investment made by the underwriters.

13. The importance of the brokers' role is explained by the mutual funds prospectus that even in its simplified form, regulated by the UCITS Directive, provides for taking into account the procedures that investors have to follow in order to underwrite and implement the various operations related to the common funds shares. In Italy the (simplified and complete) mutual funds prospectus regulation for (Italian and foreign) funds sold in Italy, requires to indicate the (underwriting, redemption and management) average amount of the commission share the managing firms reconvey to the brokers and that the mutual funds share underwriting and redemption procedures between investors and brokers be disclosed.
14. The compensation for the common funds distribution network is part of the cost borne by the mutual funds investors, basically the same of what happens for other products. The compensation for the common funds distribution network is in fact made by retrocession of the management firms to the brokers of a percentage of the underwriting, redemption and management commissions, based upon parameters connected to the amount of *asset under management* that, according to preset time intervals (normally quarters), are held by the clients of the various brokers.
15. Besides the procedures applied in this regards, the function of the retrocession of commission from mutual funds managing firms to brokers is similar to the compensation paid by the security (stocks, bonds and structured shares) issuing firms to the brokers retained to sell the shares in the market. If the CESR approach has to be followed, the examples currently provided in the consultation document should be expanded, because as of now it is focused on mutual funds and this would end up in questioning the validity of the compensations of services necessary for the underwriting of the financial tools by the investors. For sure this is not included in the purposes of the MiFID.
16. The above mentioned considerations and the ones that follow, that for what we are aware of are shared by numerous operators in the finance industry, force us to request further studies about the term *inducements* and therefore, we ask CESR to issue a second consultation document capable to define a common approach on such important issues.

Specific remarks

General explanation and relationship with conflicts of interest

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

17. ABI does not share the interpretation provided by CESR about Art. 26, according to which all the form of compensations that are different from the ones paid or received by the clients (letter a) and from the *proper fees* (letter c), would be considered inducements, and therefore subject to the terms and conditions set forth in letter (b), even if they represent the amounts due invoiced for the performance of a service.
18. According to ABI, in fact, the amounts due for the performance of a service should not be subject to any validity condition, as set forth in this regard in letter (a) and (c) of the above mentioned Art. 26.

Question 2: Do you agree with our analysis of the general operation of Article 26 of the MiFID Level 2 Implementing Directive and of its interaction with Article 21?

19. Our thoughts, that have already been expressed, both at the general level and in response to question N. 1, indicate that ABI does not agree with the CESR analysis about the application of Art. 26 also in relation to Art. 21.
20. According to ABI, we also have to take into account that:
- Art. 21, letter (e), that includes certain incentives in relation to the conflict of interests, and Art. 26, indexed as “Incentives”, present coordination difficulties because of the formulation in Art. 26 that is everything but clear;
 - The formulation of Art. 26 was very intricate in drafting the Directive because of the underlying uncertainties in identifying the application range of the rules on inducements.
21. Having said that, it is extremely important to define the application range of the rules set forth in letter (b) of Art. 26, related to the incentives, only in relation to compensations potentially capable of inducing the firm to behave in a dishonest, unfair and unprofessional manner. Such result can be reached by adopting the following interpretative approach:
- Art. 21, letter e, introduces the notion of incentives, setting the defining limits, and Art. 26 provides details about its content. Basically, Art. 21, letter (e), operates a first screening, because it defines that the amounts received

or paid by the firms from/to third parties cannot be considered as incentives, as long as such amounts are normally invoiced for services performed on behalf of the clients and it clarifies that such incentives imply the existence of a risk of conflict of interests. Art. 26 also provides substance to such notion, identifying the incentives "by difference" in relation to everything that can be considered a direct payment between the firm and their client (letter a) and the payment of services that are instrumental (letter c); but they must be part of this group and therefore only the compensations that are different from the payments normally invoiced for services provided to the clients, that just because as such present a risk of conflict of interests, can be considered as incentives;

- It is also possible to affirm that each form of compensation for services provided by the intermediary banks to their clients are anyhow in accordance with the provisions set forth in letter (a) of Art. 26. There are in fact no doubts that the compensation paid by the managing firm to the mutual fund broker represents the compensation for a service provided by an intermediary bank to their clients, even if it is not clear if such service represents an investment or ancillary service.

Article 26 (a): items "provided to or by the client"

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

22. ABI does not agree at all with CESR' interpretation of letter (a) of Art. 26, because it intends to excessively restrict the field of application. In our opinion, it would instead be possible and necessary, as we indicated in our response to question N. 2, to refer such provision to all the monetary and non-monetary compensations, in relation to the performance of services between the intermediary banks and their clients.

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

23. In line to what stated above, ABI believes it is possible and necessary to review the interpretation of Art. 26, letter (a) and to broaden the list of examples that fall in the field of application of such provision.

Article 26(b): conditions on third party receipts and payments

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

24. Considering what stated above, ABI believes it is necessary to reformulate the conditions that determine what type of paid/received compensations to/from third parties are to be considered as incentives, in order to avoid including in this group the regular compensations for services provided by the intermediary banks to their clients.

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

25. ABI does not agree with introducing a proportionality principle, taking into account that:

- The concept of “proportionality” of the incentive in regard to the value of the service provided to the client does not fall into normal standards. Instead it is the CESR interpretation of the principle set forth in Art. 26, letter (b), (ii), according to which the incentive “cannot not impair the duty of the firm to act in the best interests of the client”;
- CESR does not provide indication in relation to the subject/s called to implement such congruity checks and it does not provide the parameters to use in such operation. This would open the door to congruity checks by the financial authorities and legal disputes, with the risk of exposing to external audits the commissions applied by the intermediary banks for core services provided to their clients.

Article 26(b): disclosure

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

26. ABI agrees with CESR that it would not be useful to seek to develop guidance on the detailed content of the summary opportunity to provide the clients. However ABI

believes that it would be useful if CESR would provide a series of examples of analytical and synthetic disclosures to help the intermediary banks in setting up the two types of disclosures.

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

27. ABI agrees with CESR.

Tied agents

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

28. ABI believes that the *tied agents* are part of the distribution chain of the investment firms with the consequence that among the retrocessions made within such relationship there are standard compensations for services provided and as such released from the rules set forth in Art. 26, letter (b).

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

29. ABI believes that there are no further elements to take into account.

Softing and bundling arrangements

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

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

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

30. ABI believes it is necessary to define an homogeneous approach at European level about this issue.