

CESR CONSULTATION **Inducements under MiFID**

**Response by the French Association of Investment
Firms (Association Française des Entreprises
d'Investissement – AFEI)**

Key arguments

- To preserve a level playing field, CESR should implement a harmonised approach to Article 26 across all Member States. That said, it must make every effort to avoid unnecessarily upsetting the economic balances that exist at present.
- CESR's approach, which is focused on point (b) of Article 26, must not lead to an artificial and unwarranted widening of the scope of the article as a whole. Any additional constraints will not be legitimate or justified unless they address situations that could generate conflicts of interest.
- CESR's use of examples is particularly interesting for the purpose of constructing its analysis. However, these examples cannot replace the analysis itself, especially when they elicit comments that highlight the need for further consideration.
- CESR should address the issue of soft commissions, with a view to initiating a debate on harmonising Member States' existing rules and practices. However, that debate must not result in regulators reaching a consensus based on aggregating their best practices.

1. Further to its Level 3 work on the Markets in Financial Instruments Directive (MiFID), the Committee of European Securities Regulators (CESR) submitted a consultation paper at end-December 2006 regarding a number of recommendations for the enforcement of Article 26 of the implementing directive, which deals with inducements. AFEI, which has been closely and actively following CESR's work, takes a particular interest in the question of inducements which, as explained below, raises major policy concerns.

Before addressing the questions in the CESR consultation paper (II), AFEI wishes to submit some general comments (I).

I. - General comments

- ***Crucial for the level playing, this issue is awkward because it can needlessly upset delicate economic balances***

2. In AFEI's view it is especially important that CESR should work on drafting Level 3 recommendations for enforcing Article 26 of the implementing directive. The crux of this article is to set the limits within which market participants can pay or receive money in respect of the services they provide or benefit from. It is therefore vital that Member States' regulators should adopt a common, harmonised approach to this question under the auspices of CESR.

It is unthinkable that, in light of Article 26, a payment flow could be interpreted differently depending on the home state of each market participant. This would badly distort the level playing field.

3. However this harmonisation effort, although much-needed, cannot be undertaken without first making an in-depth analysis. It must be stressed that the way in which Article 26 is interpreted could have a profound impact on the economic balances that currently exist between the market participants providing investment services. That these balances have in many cases existed for years is certainly not an argument for keeping them in place. But it must also be noted that, at this stage, there have been no reports of serious shortcomings that could necessitate an urgent break with past practice.

Accordingly, AFEI believes that CESR should proceed with caution on this matter to avoid destabilising a certain number of market participants unnecessarily and, above all, without delivering customer benefits. To that end, CESR should aim to frame its interpretation pragmatically, taking into consideration the cases it identifies as it carries its analysis forward. For this reason, AFEI is alerting CESR to the risks of acting hastily.

4. AFEI strongly believes that a second consultation needs to be organised on the subject of inducements, based on a new draft of the interpretation document.

- ***A framework that must be put into perspective in order to fully appreciate its scope***

5. It is evident that the structure of Article 26 is somewhat misleading. Although the linear presentation of items (a), (b) and (c) suggests that they follow on from each other, they are not actually on the same level. Items (a) and (c) deal with payment flows that can be considered "normal", so that all other flows are subject to the special requirements of point (b).

Therefore, to determine the scope of Article 26, it is useful to proceed by elimination, analysing firstly the situations that come under Article 26(a), on the one hand, and Article 26(c) on the other. Thereafter it will be much easier to determine which situations truly come under Article 26(b).

6. This type of approach would be particularly useful because, in practice, points (a) and (c) cover the vast majority of situations, leaving (b) to play only a marginal role.

- ***Conflicts of interest are a focal point of analysis, particularly where payments are made in respect of a service other than the one for which Article 26 is implemented***

7. Article 26 is meaningful only if assessed in light of conflicts of interest.

- **point (a)** pertains to payments which, by nature, do not involve a conflict of interest because they flow directly between the client and the firm;
- **point (c)** pertains to situations in which the payment is made between the firm and a third party, while remaining "proper" and unlikely to create a conflict of interest.
- **point (b)** pertains to payments that might lead to a conflict of interest, authorising them only if three conditions are fulfilled:
 - o they must be transparent to the client;
 - o they must not interfere with the duty to act in the client's best interest;
 - o they must enhance service quality.

8. Conflict of interest is the focal point for analysing Article 26, and it must be taken into special consideration in the numerous situations where a payment made to a third party on account of a service provided to a client actually remunerates a service supplied by the third party to the service provider.

In many cases, the service in question consists in introducing a new client, and a fee is paid for this in accordance with standard industry practice. However, the payment is not made in a single instalment but throughout the client relationship, taking into account the value placed on that relationship by the entity benefiting from the new business. In most cases, the fee itself does not create a conflict of interest because it does not induce the supplier to act differently vis-à-vis the client. Furthermore, it is necessary for supplying the service to the client, with whom the intermediary would probably not have established a relationship had it not been for the business introducer.

This outline also demonstrates that the scope of Article 26(c) is certainly much broader than envisaged by CESR at this stage.

- ***Examples are useful when preparing the analysis but must ultimately be left aside***

9. CESR's approach based on a list of practical examples is very interesting: it allows the analysis to be grounded in real-life situations, which are worthy of attention.

However, while this approach is definitely useful when preparing the analysis, it cannot replace the analysis itself. The problem with examples is that they oversimplify, making it impossible to imagine the wide variety of situations that are encountered in the real world. They also tend to be rooted in situations that have already been experienced and do not necessarily reflect the new situations which might occur because of the often rapid pace of change in financial market activities.

10. For this reason, the final interpretation document must contain a conceptual analysis, with examples being confined to the annexes for illustrative purposes.

II.- Answers to CESR's questions

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?

11. The answer is obviously yes, because the article is worded in such a way that no other interpretations are possible. Given this obvious fact, however, care should be taken to ensure that Article 26 is not given too wide a scope. AFEI notes that the phrase "*in relation to the provision of an investment or ancillary service to a client*" introduces a limit that needs to be analysed precisely.

12. In AFEI's view, it is vital that CESR should analyse point (c) in greater depth instead of merely mentioning it in the introductory part of its paper (paragraphs 5 and 6).

AFEI notes that the list of fees and commissions set out in the article – "*custody costs, settlement and exchange fees, regulatory levies or legal fees*" – is both broad and open-ended, so it is clearly not exhaustive. Accordingly, other types of remuneration can unquestionably be considered as "proper fees" provided that they "*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*".

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?

13. AFEI strongly supports this analysis, as mentioned in §7 and §8) above.

We would also point out that, in English, the term "inducement" implies that there could be a conflict of interest. This idea does not exist in French translation of (*avantage*).

14. However AFEI considers that, paradoxically, the conclusion that there is a strong interaction between Articles 21 and 26 has not prompted CESR to hinge its analysis on the issue of conflicts of interest.

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"?

15. While AFEI has no particular comments on this analysis, we nevertheless subscribe to the view expressed in paragraph 12 that "*[t]hese examples demonstrate the limited circumstances in which Article 26(a) is relevant*".

As already mentioned in §6, Article 26(a) covers the vast majority of situations. CESR's analysis should highlight this fact.

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”?

16. AFEI has no additional examples to put forward at this stage.

Furthermore, regarding the discussion on the respective scopes of points (a), (b) and (c) of Article 26, we refer back to our remarks in §5 and §6.

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

17. AFEI fails to understand CESR's approach, which introduces a further condition through the idea of a "disproportionate" commission.

This condition, which is not provided for in Article 26(b), would not only be very hard to prove; it appears to replace – but in what capacity? – the condition of being "designed to enhance the quality of the service to the client".

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?

18. Regarding the examples presented in the paper, the fact of permitting a client to gain access to certain products that would otherwise be unavailable to him should be considered as proof that service quality has been enhanced.

More broadly, when the actual payment itself allows a service to be provided to clients, this should be considered as an enhancement of service quality. The same reasoning should also apply to client reporting, both ex ante with the supply of preliminary information, and ex post with the actual reports.

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?

19. AFEI agrees with CESR that establishing the detailed content of summary disclosures at European level is not particularly useful. However, it will be necessary to ensure that, in practice, all Member States offer the possibility of publishing summary disclosures, as provided for in the last paragraph of Article 26.

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?

20. AFEI agrees with CESR that this relationship is the key issue in Article 26, that is to say making sure that an intermediary cannot be induced to act against the best interests of its client.

However, it should also be remembered that there are several levels of client / supplier relationships in this type of situation. So CESR's question comes down to determining which client should benefit from the provisions of Article 26. This requires further consideration.

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

21. We have no suggestions on this point.

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?

22. First of all, AFEI points out that choosing to tackle the question of softing and bundling during the debate on inducements does not, in principle, preclude all these arrangements from coming within the scope of Article 26(b).

That being said, AFEI endorses this debate, for which Member States' rules and practices need to be harmonized, as regards both outlawed practices such as hard commissions and accepted ones such as softing. Harmonisation would be particularly useful since IOSCO has already commissioned work on this issue.

However, AFEI reminds CESR that this debate must not result in regulators reaching a consensus based on aggregating their best practices.

ADDITIONAL COMMENTS ON CESR'S EXAMPLES

23. The examples given by CESR are a useful basis for debate. However, after an initial analysis, AFEI wishes to submit some comments that highlight the need for further consideration.

Example 1

24. This example needs to be clarified and expanded if it is to serve as a sound basis for discussion.

AFEI notes in particular that, with many business models, the commission paid by the management company to the firm providing investment advice is disbursed over a period of time, as long as the client continues to hold the shares of the fund in question. Accordingly, the total amount actually received by the advising firm is measurable on a long-term view only, whereas the advice it provides is given at the outset. So on what basis is it possible to determine whether the commission is "disproportionate to the market" at the time the advice is provided?

In addition, surely this commission is "finder's fee" paid to the adviser for putting the fund in contact with the client? Since the fund receives a commission from the client as long as he holds his shares, is it anomalous that he should also pay the finder's fee over an extended period? (see § 8)

Example 2

25. This example calls for the same comments as those on Example 1.

The basic question is whether, in practice, the investment advice referred to in Example 1 is actually paid for.

Example 3

26. This example seems unrealistic. It assumes that the portfolio manager or the receiver and transmitter of orders is able to choose the executing broker for each order without also acting as a broker vis-à-vis the client.

In AFEI's view, this situation is impossible in France because it would mean that the client also has a direct contractual relationship with the executing broker and that, accordingly, the portfolio manager or receiver and transmitter of orders is not free to make choices at its own discretion.

27. Strangely, this example has not been approached from the angle of best execution. Surely, given the rules involved, there is an automatic "enhancement" of service quality?

Example 4

28. In CESR's analysis, the perquisites given to individual employees have been brought within the scope of Article 26. This may not be justifiable, since Article 26 applies solely to investment firms, not to their personnel.

AFEI believes that, under MiFID, supervision of employees' perquisites should be governed by the rules of ethical behaviour and thus comes within the broader framework of compliance (*see Art. 13.2 of the Level 1 Directive and Art. 6 of the Level 2 Directive*).

Example 5

29. The situation described in this example is a business introduction. CESR's must explain why this commission *"will be able to meet the test of not impairing compliance with the duty to act in the best interests of the client, in particular if the firm F is not likely to enhance the quality of the service to the client. Article 26 also requires disclosure of the arrangements"*.

As pointed out in §8, this commission does not induce the intermediary to act differently toward the client. Not only does it not create a conflict of interest; it is also needed so that the service can be supplied to the client, with whom the intermediary would not have worked had it not been for the business introducer.

Example 6

30. CESR is not very clear about who actually benefits from the one-off bonus: the intermediary or one of its employees?

If the beneficiary is an employee, then AFEI reiterates the comment made in §28.

If the firm is the beneficiary, it would be useful to clarify the link between the fee it receives and the incentive that it gives to its employee – the person who, in practice, provides the advice – and that could influence his or her judgement.

Example 7

31. As with §27, we find this example strange in that it makes absolutely no mention of best execution, the whole point of which is to ensure that brokers are chosen on the basis of objective assurances of execution quality.

Example 8

32. This example may resemble a case of inducement, but this would depend both on whether the practice was "accepted" in the market and on the size of the commissions. This example highlights yet again the vital importance of case by case analysis (see § 10).