The voice of banking & financial services

CESR CONSULTATION - INDUCEMENTS:
"Good and Poor Practices"
(*CESR/09-958*)

A response by

The British Bankers Association

December 2009

The British Bankers' Association (the "BBA") welcomes the opportunity to response to CESR's consultation, entitled 'Inducements: good and poor practices'. The BBA is the leading association for UK banking and financial services sector, speaking for over 200 banking members from 50 countries on a full range of UK and international banking issues. All the major players in the UK are members of our Association as are the large international EU banks, the US banks operating in the UK, as well as financial entities from around the world. The integrated nature of banking means that our members engage in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment bank and wealth management as well as conventional forms of banking.

III. 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?

The British Bankers Association largely agrees with CESR's views regarding the arrangements and procedures an investment firm should establish in order to ensure compliance with the MiFID inducements regime. However, firms should be permitted to create systems and controls that are proportionate to their business models. The flexibility that currently allows firms to adopt an approach that fits the nature, scale and complexity of their business is essential and needs to be maintained.

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?

Our membership accepts CESR's view that by virtue of the need to meet the requirements of the MiFID inducement rules, it is necessary for investment firms to put in place compliance controls that monitor and ensure compliance with the rules. We would like to point out however, that the measures taken by firms regarding inducements formulate only one part of a bank's compliance function as a whole. Compliance is a much broader concept, and there are other control functions within firms that help to ensure a firm is operating within the scope of the rules. Part of this will be a holistic culture of compliance by all staff, supported by robust training.

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?

Whilst it is the view of our membership that the level of approval relating to inducements policy should be left for the firm in question to decide, we agree that a firm's general approach to inducements should be approved by the compliance department – which would imply some senior management involvement (for instance, from a 'Head of Compliance'). Whilst we find CESR's term 'senior management' ambiguous, it is clear that all policies should be subject to a regular, proportionate review and approval process within a firm. However, we do not deem it

necessary for senior management to become involved in the specific details, nor the day-to-day measures taken to ensure compliance with the inducements regime. Indeed, the extent of senior management involvement in a firm's inducements policy should reflect the nature, scale and complexity of a firm's business.

IV. 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)?

Yes. We agree with CESR's view that these types of fees should be eligible for the proper fees regime (under the general category of settlement and exchange fees). We would further argue that where there is a need for firms to use an external broker in order to execute client orders, due to local restrictions or operational reasons, the payments should also fall under the definition of a proper fee. Such payments are necessary for the execution of the client's orders and are akin to exchange fees, except the fees in this instance are paid to third party brokers.

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?

Yes. We agree 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?

Based on the 'proper fees' criteria set out within Article 26(c) of MiFID, the British Bankers Association is of the view that, typically, tax sales credits are eligible for the 'proper fees' regime. They:

"enable, or are necessary for the provision of designated investment business or ancillary 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 client."

Equally, if a tax sales credit does not satisfy MiFID's 'proper fees' criteria, we would subsequently expect it to be subject to the cumulative conditions set out within Article 26(b) of MiFID.

What are Tax Sales Credits?

A tax sales credit (TSC) is an intra-group allocation to a "spoke", or relationship office of a financial institution located in one jurisdiction (the "spoke office") related to the sales activity that the spoke office undertakes for a "hub" or market-making office located in another jurisdiction (the "hub office"). A spoke office and a hub office may take the form of different legal entities or

different branches of the same entity. It is clearly possible for a financial institution to operate its business model on the basis of a combination of both types of arrangement.

Tax sales credits are a form of transfer pricing arrangement (TPA). Transfer pricing arrangements are put in place by financial institutions undertaking transactions on a cross-border basis so as to avoid double taxation under applicable tax and company law legislation. TPAs ensure that income arising from cross-border transactions is properly attributed and that there is proper accounting to the tax authorities in the relevant jurisdictions. It is also a core requirement of any TPA that transactions between connected parties are conducted on arm's length terms.

Interaction with the MiFID Inducement Rules

Firstly, tax sales credits and other forms of transfer pricing arrangements will only be subject to the requirements of Article 26 of the MiFID Implementing Directive where they amount to fees, commissions or non-monetary benefits paid or provided by or to an investment firm in relation to the provision of a MiFID investment or ancillary service to a client. Where a financial institution operates a hub-and-spoke business model, the requirements will only apply where its spoke offices and hub offices take the form of separate legal entities. In these instances, the credits will be prohibited on the grounds of being incompatible with an investment firm's obligation under Article 19(1) of MiFID to act honestly, fairly and professionally in accordance with the client's best interests – unless one of the three specified exceptions set out in Article 26 of the MiFID Implementing Directive applies.

In light of their defining features, we consider that certain tax sales credits should be categorised as 'proper fees', on account of their characteristics being consistent with the exception set out in Article 26(c) of MiFID. We are encouraged that CESR's consultation acknowledges that tax sales credits may, in the correct set of circumstances, be treated as 'proper fees'. While the Article 26(c) exception expressly mentions only custody costs, settlement and exchange fees, regulatory levies and legal fees as being capable of falling within its scope, it is clear that this list of items is intended to be illustrative rather than exhaustive. We are also encouraged that CESR has also recognised this within its consultation.

Two conditions or tests have to be satisfied under Article 26(c) of MiFID before a payment can be categorised as a proper fee. It is our view that generally, tax sales credits do satisfy both conditions, and can therefore be categorised as a 'proper fee'. That being said, it is still the responsibility of a firm to ensure that a tax sales credit successfully satisfies both tests within Article 26(c). If it does not, it must not be treated as a 'proper fee', and should either satisfy the cumulative conditions set out within Article 26(b), or cease being paid.

Condition 1 – The tax sale credit must *"enable or be necessary for the provision of designated investment business or ancillary services".*

Tax sales credits share many of the same characteristics as regulatory levies given that their existence is a direct consequence of tax and company legislation and there is no flexibility as to their calculation once the calculation methodology has been determined at the level of the group-wide global transfer pricing policy (and agreed with the relevant tax authorities).

They are necessary for the provision of MiFID investment services to clients since allocations have to be made to meet the requirements of the tax authorities in the relevant jurisdictions. The credits are put in place by financial institutions undertaking transactions on a cross-border basis so as to avoid double taxation under applicable tax and company law legislation. They ensure that the income arising from cross-border transactions is properly attributed and that there is proper accounting to the tax authorities in the relevant jurisdictions. It is unlikely that spoke offices would be able to provide these services to clients in the absence of an allocation under the transfer pricing arrangement (TPA). We therefore consider the first condition – ensuring the payment enables, or is necessary for the provision of the designated investment business or ancillary service - is met.

Condition 2 – The tax sale credit "*by its 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 client"*

Tax sales credits may be calculated by applying a fixed percentage to the notional profitability of a cross-border transaction. The notional profitability is calculated using the financial institution's internal models and is determined by a number of factors, including but not limited to, its reserves and operational and risk management model. The methodology used to calculate tax sales credits (including the appropriate fixed percentage to be applied) is agreed by financial institutions on a bilateral basis with the tax authorities in the relevant jurisdictions. The precise calculation methodology will therefore vary from institution to institution and will be subject to periodic change following ongoing discussions with the tax authorities in the relevant jurisdictions.

The methodology used to calculate tax sales credits in a financial institution operating across several jurisdictions will usually be set out in a group-wide global transfer pricing policy. A cardinal rule of this policy is that the level of the credits cannot be set or negotiated by individual business areas or business staff (i.e. the calculation methodology set out in the policy will apply in all instances). Further, the tax sales credits payable across a financial institution will net to zero from a group financial reporting perspective and will therefore have no economic impact.

This reflects the fact that the purpose of tax sales credits is to provide a mechanism for tax allocation across the different jurisdictions in which a financial institution undertakes business. It follows that tax sales credits have no role in measuring performance or calculating incentives for individual business areas or staff. The total consideration payable in respect of a transaction (i.e. price plus execution costs) is unaffected by the existence of a tax sales credit. Nor does it vary depending on whether the transaction is concluded locally or on a cross-border basis; clients pay the same consideration for an investment service irrespective of whether they deal through a Spoke Office or directly with a Hub Office. The total consideration payable in respect of any transaction will be determined in accordance with the best execution policy of the relevant financial institution, which will not take into account any tax sales credit or the fact that the spoke office and the hub office undertaking the execution of the transaction are in different jurisdictions. We therefore consider the second condition – ensuring that the payment, by its 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 client - is met.

There is a distinct difference between tax sales credits, and various other intra-group payments involving hub and/or spoke offices that do not satisfy the 'proper fees' criteria under Article 26(c), and must therefore satisfy the cumulate conditions under 26(b) before they can be paid in

relation to the provision of designated investment business or ancillary services. For instance, an 'introducer fee' payable to group entities (e.g. an asset management or private banking entity-referring business to an executing entity within the same group and receiving introducer fees from the executing entity), or a commission sharing arrangements involving group entities whereby a client is serviced by the local entity in the spoke offices and an entity in a hub office provides an execution service to the clients, whereby the entity in the hub office may pay a portion of the resulting commissions to the local entities for research or other permitted services.

In such instances, we would expect the intra-group payment to be identified as one subject to the cumulative conditions set out in Article 26(b) of the MiFID Implementing Directive, where the nature and amount (or method of calculation) of the payment would need to be disclosed to those affected clients in order for the firm in question to reach compliance. The fundamental difference between these intra-group payments and tax sales credits relates to the fact that the former are negotiated between the entities concerned and are intended to incorporate a 'profit element', whereas the latter are a fixed allocation determined independently from the relevant business areas.

Specific examples of tax sales credits in practice

Financial institutions use tax sales credits as a mechanism to allocate cost and reflect the input of overseas sales functions in sales of treasury products (although the precise terminology may vary between different institutions). Treasury products are generally sold under a hub-and-spoke business model with sales people located around the world in spoke offices and trading, execution and risk management functions located in hub offices in key locations. Where spoke offices and hub offices take the form of separate legal entities, sales staff located in spoke offices in one jurisdiction will sell products to clients either by acting on behalf of a hub office located in another jurisdiction (an agency sale) or by acting as principal with respect to the customer facing transaction and entering into a flat back-to-back transaction with the hub office (a riskless principal sale). The hub office will manage the risks associated with the transaction, regardless of whether it is an agency or riskless principal sale.

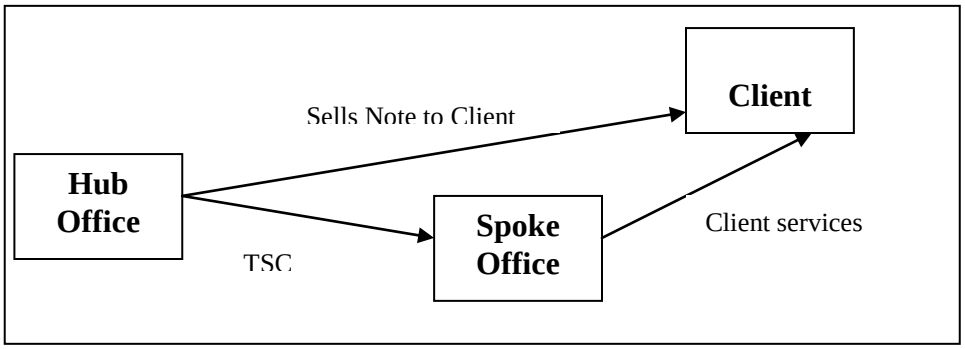
Clients may have separate terms of business with the hub office and the spoke office or a single set of terms of business covering both offices. The approach adopted will depend on a financial institution's own preferred model and will be influenced by such matters as whether the spoke office is providing a MiFID investment service (such as investment advice) to clients.

Financial institutions may use other forms of tax sales credits to compensate group entities for additional services. For example, in debt and equity origination businesses, a spoke office may provide a structuring and distribution service for a hub office. Again, compensation payments have to be agreed on an arm's length basis to ensure that the requirements of the relevant legislative provisions are satisfied.

Please find below several examples where tax sales demonstrate their eligibility for the 'proper fees' regime (NB: these examples are illustrative only and are not intended to represent all forms of tax sales credit).

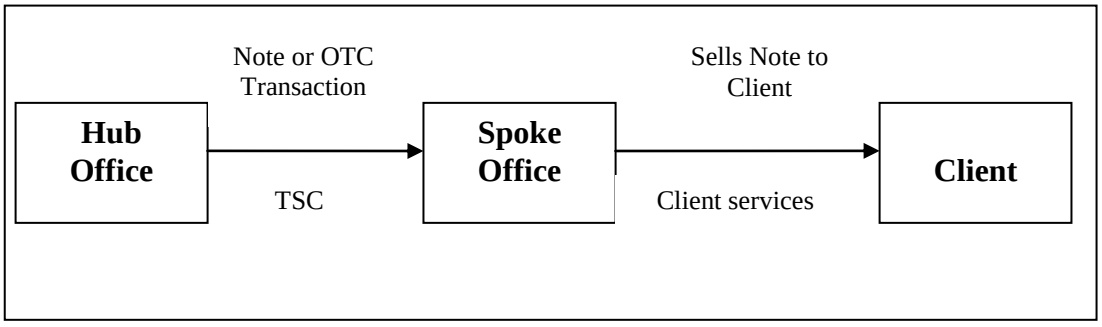
Example 1 - Agency sale

- Hub Office issues a Medium Term Note.
- Spoke Office carries out assessment in relation to the Note (including suitability assessment where investment advice is provided to the client), negotiates the sale of the Note with the client and provides on-going client support services.
- The client purchases the Note by trading with the Hub Office.
- Hub Office risk manages the transaction.
- Hub Office pays a TSC to the Spoke Office to compensate it for its services.



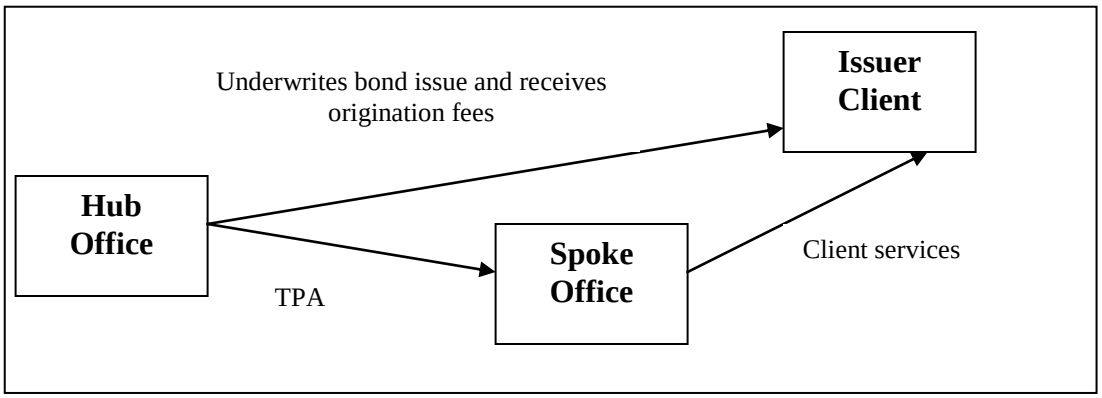
Example 2 - Back-to-back transaction

- Hub Office issues a Medium Term Note.
- Spoke Office carries out assessment in relation to the Note (including suitability assessment where investment advice is provided to the client), negotiates the sale of the Note with the client and provides on-going client support services.
- The client purchases the Note by trading with the Spoke Office.
- Spoke Office undertakes a back-to-back transaction with the Hub Office.
- Hub Office risk manages the transaction.
- Hub Office pays a TSC to the Spoke Office to compensate it for its services.



Example 3 - Debt origination

- Spoke Office contacts a potential issuer in order to pitch for a bond issuance mandate.
- Hub Office executes and underwrites the bond issue.
- Hub Office receives origination fees from the issuer.
- Hub Office pays a TPA to the Spoke Office to compensate it for its services.



V. Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of 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?

We would argue that the main consideration should be size of the overall fee rather than the frequency of payment. Such arrangements should be allowed if they meet the test of adequate disclosure – that would enable the client to make an informed decision about the arrangement. Provided that a payment (for example, from a product provider) is designed to offer a benefit to a client, it matters not whether the payment is of a one-off nature, or made on an ongoing basis.

Financial products are typically acquired with a long-term investment horizon in mind. It is normal practice in such cases that payments are made over a period of time, and banks do not believe that this would be any more problematic than a one-off payment. On the contrary, larger one-off payments could possibly create undesirable incentives to encourage more frequent client transactions (churning). Ongoing payments, tend to align the adviser's interest with those of the client, looking for suitable long-term investment products or services.

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?

We agree that an effective compliance function should be supported with appropriate monitoring and controls to deal with all potential conflicts arising from the firm's business. Please also see our answers to QI and QII above.

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?

The BBA agrees with CESR's views that product distribution and order handling services are two highly important instances where payments and non-monetary benefits received give rise to very significant potential conflicts.

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?

Whilst the payment of costs that would otherwise be charged to the client may benefit the client from an administrative viewpoint, the payment may not necessarily lead to an enhanced quality of service. Indeed, the relevant consideration should be whether a payment is designed to enhance the quality of the service (including enabling the service to be provided at all) rather than whether or not it covers costs that would have been charged to the client.

That being said, from the client's perspective, there is a distinct and direct link between the quality and the cost of a service. Therefore, if payments are made to cover costs that would otherwise have to be charged to the client, it is likely the client would benefit from having theses charges paid.

IV. 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)?

According to Article 26(b), a firm receiving or paying a fee qualifying as an inducement must disclose to the client the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, in a manner that is comprehensive, accurate and understandable, *before the provision of the service*.

There may be situations whereby exact fees cannot be disclosed before each trade. For example for some flow trades there may be very little time before each trade to enable specific fee disclosure be made. In these cases a more practical approach would be to disclose in advance a fee band or a description of the method of fee calculation, and provide further details to clients upon request.

Securities are typically offered in the inter-institutional primary bond markets immediately when the issue is launched. As order books will often be opened before the prospectus or final terms

for the issue are available, these documents will not always provide an appropriate method for any disclosure of fees to investors, and any required disclosure would have to be made to each investor when it is first contacted in relation to the issue, whether by being included in an existing document (such as a term sheet) sent to the investor at that time or in some other way. The only available means for disclosing the fees would be post-transaction disclosure. In some cases, issuers may even choose to award discretionary fees once they have assessed a transaction's performance – that is following its completion.

The need to provide a summary or full details (upon a client request) of underwriting payments should also depend upon the nature of the issue and the classification of the client. Given that the purpose of the disclosure requirements are to ensure that no client is disadvantaged by non-disclosure or a potential conflict of interest, greater care needs to be taken where there is retail client involvement. Where an issue is intended for institutional clients that would generally be aware of the costs of underwriting and commission and where the third party costs will not affect their decision to invest, disclosure is not deemed necessary. Indeed, this unnecessary disclosure of terms may in some cases actually prove detrimental if the information released benefits competitors. However, where the services being provided are intended for retail clients who are not aware of the broad terms for such services it is reasonable to expect a summarised disclosure of terms.

We agree with CESR in its view that where a fee or commission is linked in anyway to the success of the deal, a clear disclosure of the third party payments should be included within the issued documentation. In all such cases disclosure should be fair, clear and not misleading; and full details available upon request.

The examples above illustrate that as a general rule, where the quantum of a disclosable inducement is known, it should be disclosed. If the quantum is not known, but can be explained in terms of the calculation mechanism, that is the appropriate disclosure. Where neither the quantum nor the method is known, generic disclosure is appropriate, pending the availability of more information.

It is appropriate that those financial institutions electing to make a summary disclosure in the first instance inform the client that he or she may request further information (detailed disclosure) regarding the specific payment or non-monetary benefit. Furthermore, we concur that it is best practice for the firm to explicitly state how or to whom the client can make such a request.

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

We are agreeable to the provision of detailed disclosures in response to a client request. Please see our answer to Q XI above.

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

We support the use of bands as a practical alternative to disclosing the actual fee amount. Our members consider CESR correct in its assessment that many investment firms employ the use of bands in their summary disclosures; the reasons being the final level of payment cannot always be calculated prior to the provision of the service. This approach avoids the need to reprint literature when individual payments change.

We concur that the usage of bands can, potentially, be misleading - particularly the usage of maximum bands. Investment firms should certainly not use bands in such a way to deliberately mislead prospective clients. For example, it is inappropriate for a firm to state that the level of payment will fall between 0% and 50%, when in practice the minimum fee will inevitably be greater than 20%. This would give the client a distorted impression of the fee likely to be paid or received. Rather, the investment firm should disclose a payment band of between 20% and 50%.

Further, if selective investment firms are disclosing maximum investment bands that do not accurately represent the reality of the level of fee paid or received, it puts those firms which do employ accurate bands at a competitive disadvantage. This can 'lower the bar', in terms of the level of detail contained in summary disclosures across the industry. It is unlikely that an investment firm will disclose very narrow – and thus more accurate – bandings, if those other institutions it is in direct competition with, do not.

That being said, there are specific circumstances – particularly within the wholesale markets – in which it may be very complicated for an investment firm to establish the minimum fee that could potentially be paid, even though professional clients will understand that the fee is likely to fall close to the maximum fee quoted by the investment firm in the form of the disclosure band

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

Our membership is broadly in line with the views expressed by CESR regarding disclosure documentation. We agree with the importance CESR has attached to firms ensuring their disclosures are fair, clear and not misleading. Achieving this aim should take precedence over the type of documentation the disclosure is made through. We consider it less important to stipulate what form of publication should display the disclosure.

In some instances, we would consider it acceptable practice for a firm to differentiate its approach between retail and professional clients. For retail clients, to the extent possible, disclosures should be in easily accessible, consolidated documentation. However, for professional clients, firms should be afforded more flexibility to reflect the market knowledge of these clients.

Summary disclosure is not always possible in initial client information pack because fee levels are sometimes deal specific. In these cases, any disclosure would be so general that it does not provide much value to clients. Firms should be given the flexibility to disclose fees to clients using the most appropriate medium.

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

Article 26(b) of the second implementing Directive clearly obliges firms to apply disclosure requirements equally across all categories of client. However, disclosures relating to third party payments and non-monetary benefits should also comply with Article 19(2) of MiFID:

"all information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading".

The BBA supports CESR in its assessment that what constitutes 'fair, clear and not misleading' information is clearly influenced by the type of client being offered the investment service.

Professional clients are expected to have a greater depth of knowledge and experience, and are thus better placed to make their own investment decisions. It is legitimate for investment firms to take this into account, and therefore draw a distinction - albeit a subtle one - between retail and professional investors when drafting summary and detailed disclosures under the MiFID inducements rules. For instance, it would be sufficient for a firm to disclose just the formula for calculation of payment to a professional investor, whereas this may not be commensurable for retail clients. Thus investment firms offering their services to both retail and professional clients will likely use a universal disclosure across both sets of client. Therefore the extent to which there is a differentiation in disclosures is mainly between firms, or business units who deal with retail clients and firms, or business units that do not offer their services to retail clients.

If you would like to discuss any aspects of this response in further detail, please contact Christopher Ford of the British Bankers' Association [+44 (0) 20 7216 8895, christopher.ford@bba.org.uk].