

INDUCEMENTS UNDER MiFID PUBLIC CONSULTATION FBF'S RESPONSE

EXECUTIVE SUMMARY

1. The French Banking Federation (FBF) is the professional body representing over 500 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

2. As Universal Banks, FBF members are highly concerned by the interpretation of MiFID's provisions on inducements, especially in the context of the distribution of financial products. In their view, the interpretation made in CESR's consultation paper of MiFID's provisions on inducements is not relevant, since CESR seeks to apply the term "inducement" to a far wider range of payments and benefits than is intended in the Directive.

As it appeared during the Hearing organised by CESR on the 2nd of February, this view of the FBF is shared by the entire European banking industry and the entire European asset management industry.

The feeling of the French banking industry is that CESR arrives at such a result by reading the wide range of payments covered by Article 26 as inducements, whereas Recital 40 and Article 26(a) and 26(c) interact in such a way to narrow this reading.¹

3. The analysis of the FBF is based on two rationales: a legal rationale of the level 1 and level 2 provisions, and an economic rationale. At the end of the general remarks, the FBF presents its analysis of the services provided by the distributors of financial instruments and would like to underline that if many analysis are based on the example of the distribution of UCITS, these analysis are also applicable to any financial instruments created by a producer and commercialised by a distributor (for example structured products or derivatives products on the wholesale market).

Legal analysis

4. The rationale of the FBF on the interpretation which should be given to the term inducement is the following.

¹ From FBF's point of view, the MiFID shall be read as follows:

- Article 26(a) excludes from Article 26 all payments by or to a client or a third party acting on the client's behalf;
- Article 26(c) excludes from Article 26 all proper fees for contributions to the service provided to the client. Moreover, the language of Article 26(c), which refers to payments which 'cannot, by their nature, give rise to conflicts', demonstrates that the principle of conflict is implicit in the concept of an inducement; and
- Recital 40 interprets what remains – Article 26(b) as applying only to inducements, i.e. payments by or to third parties whose purpose is to induce the recipient to act differently from how they would otherwise have done, and contrary to the best interests of the client.

CESR's point of departure should be Article 19.1 of the MiFID Level 1 text which places an obligation on firms to act "*honestly, fairly and professionally*" and applies to payments that do not meet the criteria set out in Article 26 of the Level 2 implementing Directive. If this were the case then this would also point to the need to narrow what CESR could consider to be an "*inducement*". Thus CESR's apparent reading of the text seems far too broad. Consequently the FBF calls on CESR to review and narrow the scope of what it considers to be an inducement taking into account the rationale for doing so which we set out below.

Fundamentally, the FBF believes that **remuneration must involve a potential conflict of interest in order for it to be classified as an inducement**. Therefore it follows that Article 26(b) should only apply to payments by or to third parties whose purpose is to induce the recipient to act differently from how they would otherwise have done, and contrary to the best interest of the client as we state above. CESR should establish a clear distinction between fees which are purely remuneration for services performed and inducements proper.

5. Other way, CESR is adding complexity to the relatively straightforward Level 2 text which establishes when inducements are prohibited and when they are not. A clear example of CESR adding complexity is in its introduction of the "proportionality test." If such a test were to be introduced, firms would have to prove that the service had been improved rather than have a motive of improving the service, which we understand to be the spirit of the MiFID definition of what an inducement ought to be. We therefore urge CESR to be cautious when it comes to interpreting Article 26 of MiFID Level 2.

6. In conclusion of the legal analysis, CESR's paper would do better to focus on the practical steps its members could take to facilitate the smooth implementation of the MiFID text as regards inducements.

Economic analysis

7. Generally speaking, an interpretation which does not link the inducement to the situations where there is a conflict of interests would have the adverse effect than those which are to be met by the Directive, *i.e.* to give more protection to the final investors, although the actual remuneration system has positive impact on both final investors, distributors and producers and although the inclusion of such arrangements within the scope of "inducements rules" would have a negative impact on final investors, in distributors and on producers.

8. **Regarding the distributors**, it would involve a pressure on producers to lower their commissions and profitability would consequently decrease. Then it would necessarily lead to a slump in distribution activities to the detriment of financial innovation in European markets. It would also lead to a concentration of players, as only the large network would be able to face the loss of revenue.

9. **Regarding the final investor**, Lower commissions for distributors would necessarily impair the quality of the service provided to the final investor, in terms of product liquidity, innovation, and product range diversity, suitability with regard to the client's needs or linked services (reporting, advice...). Indeed, the distributor is aware of the profile and needs of the investors (both retail and professionals). Thus, as the distributor can give the producer information on these needs and therefore on the products which have to be produced to meet the demand.

10. **Regarding the producers**, they would be less motivated to create new products if the distribution channels are paralyzed by rules which are inappropriate. Finally, it should be noted that the financial products distribution market is already very competitive, with distributors organizing a request for proposals and ideas almost systematically according to their needs and those of the final investors.

11. Regarding the competition between the products. The efficiency of the selling of financial products and their adequacy to investors' needs depend largely on the capacity of banks to distribute a wide category of financial instruments. The more stringent the rules applicable to the distributors' remunerations will be, the more difficult the distribution will be. There could be a shift to products not covered by MiFID with the risk that these products would not be suitable for the clients.

FBF's view on the distribution of Financial instruments

12. The FBF would like to clearly show why the architecture of the distribution of financial instruments does not give rise to inducements. What CESR should take into account is that the distributor provides firstly a service to the producer, and secondly a service to the final investor. The distributor has two clients at different levels.

13. Firstly, the distributor provides an investment service to the producer. The commission received by the distributor from the producer is the remuneration of this service: the placing of financial instruments, *i.e.* the distributor gives to the instruments a direct access to a large public.

The FBF underlines that such placing is not comparable to the primary offerings such as IPOs, since the placing is "on the demand" of the investors. This service is provided on a long term period.

As a consequence, the banking industry states that the producer is the client of the distributor. Thus the commission is undoubtedly within the scope of the article 26 (a) of the level 2 Directive.

14. Secondly, the distributor receives an entrance fee from the final investor which remunerates the investment service of reception and transmission of orders. The final investor is his client, and the commission is also within the scope of the article 26 (a) of the level 2 Directive.

15. The FBF therefore calls on CESR to fundamentally modify its analysis on the examples 1 and 2, since the presentation made by CESR does not correspond to the reality of the services provided and of the architecture of distribution of financial instruments.

FBF's view on the introducing broker activities

16. The FBF does not share CESR's view on the scope of the article 26© of the Level 2 Directive. Indeed, CESR states that "*any items that are not of a type similar to the costs [article 26 c] mentions...are unlikely to fall within this exception*". On the contrary, the FBF considers that "*proper fees*" should be interpreted broadly as including any commissions which represent a payment due for access to a distribution channel or any payment made to an introducing broker.

17. For example, if bank A introduces one of its clients to bank B and is paid for that (commission of intermediation), we believe that the remuneration of bank A (acting as intermediary or introducing broker) should not be subject to the three conditions of article 26(b) because the remuneration is necessary for the provision of the service. If bank A (introducing broker) had not introduced the client to bank B, there would have been no service provided to the final investor. So the FBF strongly believes that such a case should benefit from the article 26 (c) exemption.

18. Moreover, the FBF considers that the article 26 (c) exemptions should not only apply to investment services but also to ancillary services. Given the spirit of the text, ancillary services have been left out inadvertently. It seems logical that, where an ancillary service is provided, the investment firm should be exempted from the three conditions already mentioned, when it receives or pays a remuneration which is necessary for the provision of the service.

DETAILED COMMENTS

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?

19. The FBF does not agree with CESR's analysis. The effect of Articles 26(a), 26(c), and Recital 40 is to limit Article 26 only to fees, commissions, and non-monetary benefits that are inducements, *i.e.* third party payments whose purpose is to induce someone to act in a way that they would not otherwise have done and which would materially affect a client to whom a firm owes a duty. This is why we state in our general remarks that the classification of inducements must take into account the practical reasons why payments are made between different intermediaries.

20. A broader scope created by CESR's interpretation of article 26 would certainly have a direct impact on certain commercial practices and activities which were acceptable until now. For example, relations with introducing brokers or commissions received when a UCITS is commercialized. The position adopted by CESR would result in an obligation to provide clients with details of the various distribution and commercialization agreements, which are by nature complex and constantly changing, without contributing to the improvement of the client process for selecting products.

Question 2: Do you agree with CESR's analysis of the general operation of Article 26 of the MIFID Level 2 Implementing Directive and of its interaction with Article 21?

21. The FBF does not share CESR's view. However, some of CESR's analysis supports the correct interpretation, as described above, that Article 26 has a narrow application which is consistent with the range of application of Article 21. For example, paragraph 35: "*CESR considers that the arrangements that need to be considered and, where relevant, disclosed...are those that can influence or induce the investment firm...which has the direct relationship with the client*" sets out an approach which should underlie the whole of CESR's analysis. We would encourage CESR therefore to adopt such an approach when it comes to revisit its proposed guidance.

22. More generally, the FBF considers that formal communication of a conflict of interest policy to investors should be sufficient in most cases to guarantee the management and prevention of any eventual conflict of interests.

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"?

23. The FBF does not fully agree with CESR's view. We believe that CESR should not seek to limit Article 26(a) to circumstances where the third party acts on a specific instruction. The drafting of the MIFID provisions supports a much wider interpretation. It should be interpreted as covering any circumstances in which the payer or receiver acts on the client's behalf, including for example commission sharing arrangements that represent remuneration for the recipient's contribution to the service, and do not induce the recipient to act in a way that would materially affect the client's interests.

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"?

24. There will be a wide range of circumstances in addition to those that CESR identifies where an item should be treated as a fee, commission, or non-monetary benefit provided to or paid by the client or a person acting on behalf of the client. Circumstances could include normal commercial commission sharing arrangements, because they constitute compensation for part of the services provided to the client.

25. The FBF also considers that the services provided between financial intermediaries (such as distribution, introduction, etc.) are done for the benefit of investors and are essential, because without them no service could be provided to the final investors. Producers of financial instruments are obliged to enter into distribution agreements to be able to sell products to investors, unless they have their own network (closed circuit).

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?

The FBF's does not understand on which situation CESR refers to in the examples 6 and 8. Thus the FBF asks CESR for clarification with respect to:

Example 6:

CESR states that an arrangement where the investment firm receives a one off bonus payment under the sole condition that sales of a particular product reach an agreed level appears unlikely to enhance the quality of the service to the firm's client. Based on this, we understand that an agreement between an investment firms and its service providers based on which an investment firms receives a higher rebate once the total Assets under Management in a fund range has reached a certain level, is acceptable since this agreement is not a one-off bonus and does not relate to one particular product.

Example 8:

In our view, the situation described by CESR in example 8 is a normal commission sharing arrangement. If investment firms would have to repay to its clients the commissions received from the UCITS management company based on the product charges made to the client, this would have very heavy commercial and operational implications for investment firms. Therefore, the most likely solution for investment firms would be to increase their management fees to compensate the loss of income.

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?

26. The FBF stresses the importance of a broad interpretation of the requirement that an inducement must be designed to enhance the quality of the service to the client, without prejudice to the fact that this requirement is only applicable to the cases where the remuneration may be considered as an inducement.

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 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?

27. The FBF agrees that it would not be useful for CESR to seek to develop detailed guidance on the content of summary disclosures. Since such guidance would have to be suitable for all investment firms in all relevant businesses in relation to all clients, CESR is right to only propose high level guidance along the lines of what it states above. Instead a general description would be sufficient.

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?

28. The FBF agrees with CESR's approach in this area.

Tied agents

29. At this stage, the FBF has no comments as regards Tied Agents and inducements.

Softing and bundling arrangements

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

30. Theoretically, there would be undoubted advantages to a common approach across the EU to softing and bundling arrangements. However, any approach should be market driven and accommodate of current arrangements and local market specificities, so this task maybe more difficult to perform in practice. At this stage, the FBF does not consider appropriate or helpful for CESR to develop that common approach.