

INVERCO ANSWER TO CESR CONSULTATION ON INDUCEMENTS

INVERCO, the Spanish Association of Collective Investment Schemes and Pension Funds, thanks CESR for the opportunity to participate in this consultation process. We hope our comments to be useful and taken into consideration in the final CESR's recommendation to its members.

INVERCO represents more than six thousands collective investment schemes and almost a thousand pension funds, with more than EUR 415 billions in assets under management.

The following document is divided into two sections. The first one summarizes the arguments underpinning the answers to the questions included in the second part.

1. GENERAL COMMENTS

- The concept of inducement is not established by the Level I Directive, but it is developed by articles 21 and 26 of the Level II Directive, as an implementing measure of both articles 18 (conflicts of interest) and 19.1 (obligation of acting honestly, fairly and professionally, in accordance with the best interests of its clients) of the Level I Directive. Likewise, article 64 of the Level I Directive requires that such implementing measures *"do not modify the essential provisions of that Directive"*, therefore ***interpretation and application of the inducements regime should be confined to the scope of conflicts of interest and duty of acting properly.***
- ***Obligation of acting honestly, fairly and professionally in accordance with the best interests of its clients, established by Article 19 of the Level I Directive, is not incompatible with the perception by investments firms of a proper remuneration;*** moreover, a proper remuneration can be considered as a guarantee of an honest, fair and professional actuation, in accordance with the best interests of the clients.

Nonetheless, the approach proposed in the consultation paper puts under a *"presumption of guilt"* to any payment in relation with an investment service received by an investment firm from a third (different from the client). The adjective *"not-prohibited"*, instead of *"permitted"*, used to classify those inducements that fulfill the requirements under article 26, highlights this treatment.

According to Paragraph 9 of the document, *"In principle a payment to a third party or a receipt from a third party in relation to a service provided to a client could put the investment firm in breach of its duty to act in the best interests of the client. So, such a receipt or payment creates a potential conflict of interest between the investment firm and its client"*. In our opinion, there are some cases in which this approach should not apply. For example, when a client comes into a bank office to buy some units of a particular collective investment scheme, that he or she has previously decided (according to the information available in the internet, press or wherever), the bank is not providing a service of portfolio management or investment advice, since the client has taken the decision by his own. In this example, the bank is acting like a sales agent, and provides a distribution service to the management company, by which they have arranged some commissions. These commissions do not give rise to a conflict of interest, nor impair the firm's duty to act properly, since the decision of the client is not influenced by the bank. In this situation, ***there is no reason for the bank to disclosure commissions, which constitute the proper remuneration for the distribution service provided to the management company, necessary for making the collective investment schemes available to the public; furthermore, these commissions have no impact on the decision or on the investment profitability for the client, so the features of a conflict of interest, as***

considered in Recital 24 of the Level II Directive, are not present (“It is not enough that the firm may gain a benefit if there is not also a possible disadvantage to a client”).

- ***Inducements should be confined to the context of both conflicts of interest or impairment of the obligation of acting properly, and therefore, disclosure should only be required in a limited number of situations.*** Payments and receipts to or by the investment firm may be a source of conflict of interest, but not the only one; in the same way, ***the existence of an inducement is not inseparable from the rising of a conflict of interest.*** So, in our opinion, ***the investment firm should only comply with requirements established by the article 26 as long as the particular inducement gives rise to a conflict of interest or impairs its duty to act properly,*** and not in any other situation.

The approach we propose operates as follows:

- the investment firm has to identify what kinds of inducements give rise to conflicts of interest or impair the investment firm's duty to act in accordance with article 19.1 of the Level I Directive;
 - only for those types of inducements, the investment firm has to establish organisational and administrative arrangements to avoid detrimental effects on its clients;
 - if the firm can not ensure the protection of the client interests, the inducement shall be prohibited, unless three requirements are fulfilled, namely:
 - a) prior disclosure,
 - b) inducement designed to enhance the quality of the service and,
 - c) impairment test of compliance with the firm's duty to act in the best interests of its clients.
- ***Requiring disclosure of any commission perceived by the investment firm from a management company in return for distribution of collective investment schemes, regardless the arising of a conflict of interest, involves a lot of drawbacks,*** in particular:
 - a) ***Distortion of the agreements between management companies and distributors and serious risk of higher distribution costs.*** The disclosure proposed implies a breach of the confidentiality that governs the negotiations between management company and distributors. These negotiations determine that commissions arranged may differ from one distributor to another, according to aspects such as the size of its distribution network, the number of clients, its reputation or the provision of ancillary services; in this context, ***confidentiality is of strategic importance, since it allows management companies to obtain lower distribution costs, savings that can be passed on to investors through lower management fees.***
 - b) ***No additional benefit for investors.*** Collective investment schemes, in particular those harmonized at EU level, have their own regime of information, which requires a prior disclosure of any commissions and/or expenses to be charged to the unitholder; so, ***the disclosure of how these commissions are allocated between the members of the distribution channel does not constitute an additional benefit for investors, since this allocation has no impact on their investment profitability.***
 - c) ***Discouragement to open architecture.*** Requiring disclosure of any distribution fee benefits the distribution of in-house products, in detriment of the establishment of open architecture structures, which have proved to be a perfect mean to promote unbiased advice, diversification, flexibility and efficiency.
 - d) ***Detriment to collective investment schemes competitive position.*** The position of CIS, in particular those harmonized at EU level, in comparison with other substitute products, could be already damaged, as remarked in the “*Green Paper on the enhancement of the EU framework for investment funds*”, since all of them compete for long-term savings, but they are not necessarily subject to the same level of disclosure and transparency. This new proposal on inducements could, in

addition, discourage investment firms from distributing CIS in favour of other substitute financial products, that may be not subject to this provisions, in order to avoid the disclosure of their fees.

Apart from these drawbacks, we would like to highlight that, the ***disclosure of the firms benefits to their clients, regardless the existence of a conflict of interest or the impairment of the duty of acting properly, is a practice not required to any financial or non financial service***, since it is contrary to the free-market economy.

- Without prejudice to our previous arguments, by which disclosure should only be required under exceptional circumstances, ***the document does not shed any light about the requirements that disclosure should have to comply with***, in particular those related to the minimum content required (not only in the summary information, but also in the comprehensive one), or whether the information should be publicly available or should only be provided to the client involved in the transaction. ***In addition, CESR goes beyond MIFID when introducing some abstract concepts***, such as “disproportionate to the market” or “disproportionate benefit to the firm relative to the value of the service provided to the client”, ***that are not mentioned in the Directive and exceed its scope***.

In spite of our opinion that such abstract concepts should be avoided, in case that CESR decides to uphold them, further comments are necessary.

In the first place, it is worth mentioning that these concepts, when misinterpreted, ***could bring some proper under the free-market economy rules and widespread practices to an end***, for example, those whereby the percentage of commission to receive by the distributor, instead of being fixed, increases with the volume distributed.

In the second place, the concept “disproportionate to the market” gives rise to an uncertainty, namely which market is in charge of setting up the standard. In our opinion, ***the selection of a concrete market to act as a yardstick for the rest is only acceptable if all the markets under comparison have the same fee structure. Nevertheless, the fact is that, at least, two different models for the distributor’s remuneration can be distinguished***. In the first model, that could be called the “subscription and redemption fee model”, such subscription and/or redemption fee, usually established as a percentage of the net asset value, is received by the distributor as a remuneration for the provision of the distribution service. In the second model, that could be called the “management fee model”, the distributor receives a percentage of the management fee from the management company. In same cases, the percentage of the management fee is fixed, while in other cases it can vary according to the volume distributed. Likewise, the total fee to receive is usually calculated at the end of the year, according to the total sales achieved by the distributor. A “mixed model” is also possible, whereby the distributor receives a subscription fee, as well as a percentage of the management fee.

Each model has a different grade of acceptance, depending on the country. For example, most of the distribution agreements in Spain fit the “management fee model”, while the “subscription and redemption fee model” is rarely used. This practice is completely opposite to that carried out by other european countries, in which distributors are mainly remunerated through subscription and redemption fees.

Provided that one of the aims of the Directive is to enhance a single market, it should be the european market, and not the national ones, the standard to determine whether a commission is proportioned or disproportioned to the market. However, the existence of different fee structure models make it impossible to establish a standard, valid for the european single market as a whole.

- According to Recital 54 of the Level II Directive, “it is not the purpose of this Directive to regulate the content of the simplified prospectus as defined by Article 28 of Directive

85/611/EEC. No information should be added to the simplified prospectus as a result of the implementation of this Directive". Furthermore, Recital 55 states that "The simplified prospectus provides, notably, sufficient information in relation to the costs and associated charges in respect to the UCITS itself". For this reasons, **no information of the distribution costs should be included in the prospectus** as a result of the definite CESR's approach on inducement.

- We would appreciate and it would be **a valuable contribution from CESR, to develop an european common approach to softing and bundling arrangements, as long as this approach takes into account the benefits of these arrangements** (and not only their drawbacks), **and does not imply a break with the current international financial markets practices.**

As a final general comment, CESR's interpretation of inducements under MIFID seems to be **focused on collective investment schemes and based on a negative perception of its working**. Some of the measures proposed are prejudicial to the collective investment schemes distribution, specially those that oblige to disclose the commissions perceived by distributor. The distribution of other substitute products, such as structured notes, unit-linked life insurances or certificates, might not be under the same transparency requirements, so this different treatment poses a **serious threat to the collective investment schemes industry**. It is fundamental to highlight that banks and saving banks, that concentrate most of the CIS distribution in a lot of EU members, including Spain, do not owe a duty of suitability to their clients where distributing products without providing investment advice; so, CESR's approach provides them with **a clear incentive to distribute those products which are not subject to disclosure requirements, in order to avoid a transparency that seems to be reserved for collective investment schemes**.

2. ANSWERS TO THE QUESTIONS

Section 1: 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?

No. **Articles 18 (1) and (2) of the Level I Directive** require investment firms to take all reasonable steps to **identify conflicts of interest**, and only where organisational or administrative arrangements made are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on his behalf. According to this article, **prior disclosure only takes place, provided that two conditions are met:**

- A conflict of interest has been identified.
- The arrangements made by the investment firm are not sufficient to avoid a risk of impairment of client interests.

In addition, **Article 21 of the Level II Directive** sets out a list of **minimum criteria that must be taken into account to identify a conflict of interest**, and includes inducement amongst these criteria. Finally, its Article 26 establishes the **conditions to determine whether an inducement shall be considered prohibited or non-prohibited**.

According to our perception, an overall analysis of these three articles leads to the conclusion that **inducements should be treated in the context of conflicts of interest**, and therefore:

- The investment firm shall take all reasonable steps to identify conflicts of interest. In our opinion, **when distributing products, a conflict of interest arises where the decision of the client depends on, or can be affected, influenced or induced by, an investment firm, whose conduct can also be biased, due to the existence of an inducement. This ability to interfere in the decision of the client only appears in some investment services, in particular those related to portfolio management and investment advice**, and not in the remaining investment services and ancillary services listed in Section A of Annex I of Directive 2004/39.

For this reason, **the application of the Article 26 to investment firms when distributing products (in particular, investment funds) should be limited to those situations in which the firm, as well as distributor, acts as a provider of portfolio management and/or investment advice services**.

- Once identified (and only in this case), the investment firm shall maintain and operate effective organizational and administrative arrangements with a view to taking all **reasonable steps designed to prevent these previously identified conflicts of interest affecting adversely the interests of its clients**. As we have expressed in the previous point, we accept that a conflict of interests arises where the investment firms provides services of portfolio management and/or investment advice and, simultaneously, receives an inducement from the product provider. This conflict of interest operates as follows: the investment firm buy on behalf of the client (in the case of portfolio management service) or advise the client to buy (in the case of investment advice service) a particular product, and, as a consequence of the sale, receives a fee, commission or non monetary benefit from the product provider. There is a risk that the purchase of the product (or the recommendation of

purchase) by the investment firm may be biased by the existence of an inducement, and not based on the suitability for the client of the particular product.

- **Only if arrangements made can not ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the prior disclosure to the client shall be required.** In addition, the inducement will have to be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.

Nevertheless, in our opinion, **CESR holds a too wide application of article 26**, so that, except for those inducements provided to or by the clients and those considered proper fees, all and any fees, commissions and non-monetary benefits should comply with the requirements set out in article 26, in particular, the prior disclosure. For these purposes, it results very explanatory the second example provided by CESR (Paragraph 25), in which an investment firm, that is not providing investment advice or general recommendations, has a distribution agreement with a management company of a UCITS, to distribute its products in return for commission. CESR's view is that the condition of being designed to enhance the quality of the service to the client may be considered to be met, but the other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty to act in the best interests of the client- will also have to be met.

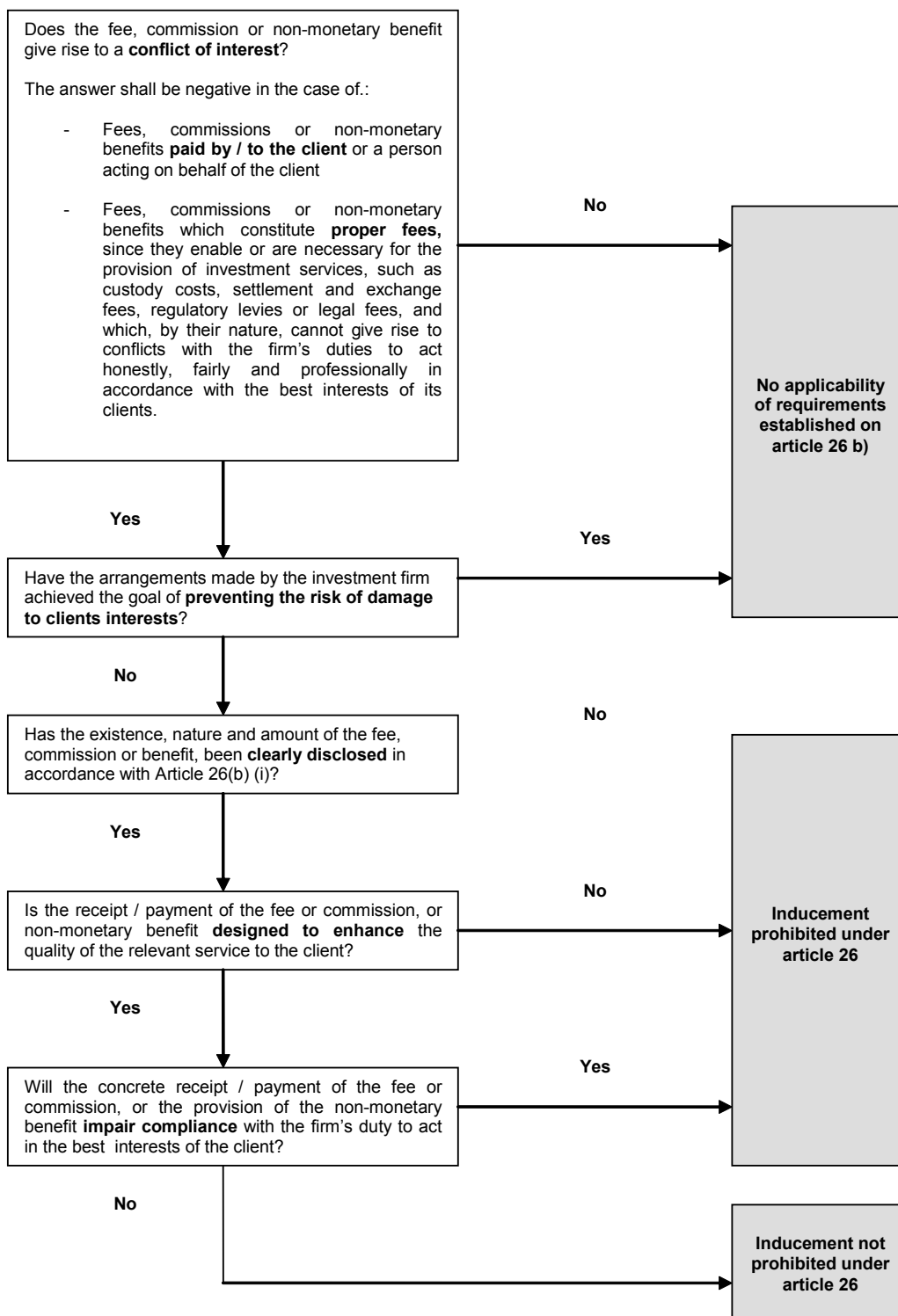
It does not seem understandable how this all-inclusive disclosure requirement contributes to the aims of the Directive. So, **Recital 5 of the Directive 2006/73/EC** establishes that. **"The rules for the implementation of the regime governing operating conditions for the performance of investment and ancillary services and investment activities should reflect the aim underlying that regime. That is to say, they should be designed to ensure a high level of investor protection to be applied in a uniform manner through the introduction of clear standards and requirements governing the relationship between an investment firm and its client."** If the aim is the investors protection, the disclosure should be required when their interests are put at risk, but not in any other situation. **It seems disproportionate to require the disclosure of any incentive, even if it does not constitute a conflict of interest; moreover, this kind of disclosure is not required to any other financial or non financial services, and is contrary to free-market economy.**

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?
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All the situations listed in the article 21 are criteria to identify conflicts of interest, but not conflicts of interest by themselves. So, the article states that, for the purposes of identifying the types of conflict of interest, investment firms shall take into account, by way of minimum criteria, if they are involved in one of the listed situations, but it does not say that, whenever the firm is in one of this situation, a conflict of interest arises.

In fact, when the aim of the Directive is to establish a fixed definition, the wording is notably different from that used in article 21, as shown in the following examples: **article 11** (personal transaction **means** a trade in a financial instrument effected by or on behalf of a relevant person, **where at least one of the following criteria are met...**) or **article 13** (an operational function **shall be regarded as** critical or important **if** a defect or failure in its performance would materially impair the continuing compliance of an investment firm...).

Taking into account all the arguments set out up to now, we propose the following alternative flow chart to illustrate how we understand the interaction between articles 21 and 26:



Finally, we do not agree with CESR about the restricted scope of Article 26 (c). In our opinion, the interpretation of Article 26 (c) should be in a wide way if the payment complies with the criteria of being necessary for the provision of the investment service and do not rise to conflicts with the firms duty to act honestly, fairly and professionally in accordance to the best interest of the client. Today there are many fees and commissions that are a straightforward remuneration for services performed, without any element which is intended to introduce the recipient to do

anything other than provide the service that is paid for. From this point of view, proper fees should be interpreted broadly, especially taking into account also that, as the markets changes, it could change also the items and cost associated with the services, with their process and with the market practices of the provision of investments services, so it is important to keep open the possibility of permitting any fee that meets the criteria. The CESR is proposing a restricted interpretation that could close at present and in the future the possibility to charge new "proper fees".

Section 2: 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"?

Yes, we share CESR's view. Nonetheless, according to CESR's interpretation, when the product provider pays a share of commission to an investment firm, always, or almost always, will be dealt with under article 26(b); but this interpretation implies that in such cases there is no possibility to get an explicit instruction from the client, (particularly professionals but also retailers) and, in fact, this could be the case at the time of establishing the contract with the client.

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"?

We have not identified any other.

Section 3: 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?

Examples proposed in the present consultation paper are almost exclusively focused on collective investment schemes and their management companies.

It would be convenient for a proper interpretation of article 26 that ***CESR would provide mixed examples, including a number of examples concerning the substitute financial products of collective investment schemes*** quoted by the European Commission in its "White Paper on enhancing the single market framework for investment funds", such as unit-linked life insurances, structured notes and certificates, or bank deposits, among others.

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?

As a general comment, we consider that CESR might exceed MIFID scope where establishing new concepts, such as disproportionate to the market.

Without prejudice to this previous comment, it would be convenient that **CESR would clarify when a commission should be considered disproportionate** (*Example 2, Paragraph 25*) **to the market or when it gives disproportionate benefit to the firm relative to the value of the service provided to the client.** Furthermore, the proportionality to the market raises the problem, among others, of the identification of the particular market to use as a standard (domestic market, european market, financial market in general, or only the collective investment schemes market, among others). So, which market should be the reference?; depending on this decision, the inducement shall be considered prohibited or not prohibited, situation that involves a great deal of uncertainty on the treatment of this question.

Finally, **the concept of “proportionality” should be dissociated from widespread practices**, based on the free-market economy principles, whereby the percentage of commission to receive by the distributor, instead of being fixed, increases with the volume distributed.

Section 4: 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?

Information to clients is one of the hot topics of this consultation paper. In our opinion, **disclosure should be:**

- **Restricted to situations where it is necessary.** It is a fact that investors have to receive clear and focused information to understand the main features of their investment, but the benefits for the clients are not proportional to the amount of information received. Too much information can confuse, and indeed detract from, the key messages. So, **disclosure should be restricted to those inducements that give rise to a conflict of interest, which are the only relevant to the clients.**
- **Handled with care**, if it is not no be misleading.
- **Harmonized at the european level.**

In this sense, it seem to us **fundamental that CESR would develop guidelines to detail the content of the summary disclosure**, since it is precisely the information provided in a summary way the more frequently consulted by the clients.

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?

We completely agree with this approach, as it is based on the same arguments that we have set out in our answer to question 1, namely that **a fee, commission or non-monetary benefit is relevant for the purposes of article 26, only if it can influence or induce the intermediary that has the direct relationship with the client, giving rise to a conflict of interest.**

Section 5: 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?

We agree with CESR's analysis.

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

No other, in our opinion.

Section 6: Softing and bundling arrangements

First of all, we would like to make some comments, not directly questioned by CESR. In the first place, ***CESR's approach to softing and bundling arrangements only highlights their drawbacks, while it is a fact that this kind of arrangements, when properly managed, have a lot of benefits.*** According to the recently published consultation report by IOSCO, entitled "Soft Commission arrangements", dealing about arrangements involving collective investment schemes, states that *"We note, however, that soft commission arrangements can provide benefits to CIS investors, provided that those conflicts of interest are adequately addressed by the CIS operators"*. Amongst these benefits, the following are mentioned:

- In some jurisdictions, they are an accepted and traditional mechanism by which CIS operators obtain ***valuable investment research***.
- Soft commission arrangements can be used to pay for ***research that is provided by persons that are independent*** of the broker-dealer that executes the CIS's portfolio securities transactions. Such research can be of a ***high quality and of great use*** to the CIS operator in managing the CIS that generated the soft commissions.
- Soft commission arrangements may ***facilitate research into a greater number of companies*** because such arrangements make it possible for smaller institutions to produce research in niche markets that might otherwise be ignored.
- These arrangements could represent ***'optimal' levels of research consumption***, and ***avoid the underutilization of research***, that takes place when operators are forced to pay for it directly, since only those CIS operators that are compensated based on the profitability of their investment strategies (as opposed to those that charge a fixed management fee percentage over the volume of assets in the fund) will allocate an optimal level of their own assets to research services.

In the second place, it is worth mentioning that ***IOSCO places softing and bundling arrangements in the field of conflict of interests***, that is the perspective from which they, in our opinion, should be analyzed. In this sense, ***any incentive or softing and bundling arrangements that do not give rise to a conflict of interest should never be under the scope of article 26 nor, therefore, be subject to disclosure obligations.***

Once commented these aspects, we proceed to answer the last three questions.

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

We do not have enough information to analyze this impact.

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

Yes. Moreover, this common approach should take into account the international character of financial services and markets, and their current practices, in order to avoid detrimental effects on the competitive position of the EU members, as well as a reduction in the range of providers, specially those not subjected to these common approach .

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

Yes, in our opinion CESR is the best body to this challenge, since it joins the European Regulators and gives, both the consumers and the industry, the chance to express their views in the items proposed.

Madrid, 7th February, 2007