9 February 2007

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008 Paris
France

Dear Sirs

Response to the public consultation on Inducements under MiFID (CESR/06-687)

The Investment Management Association (IMA) is the trade body representing the UK asset management industry[1].

We welcome this public consultation, and were pleased to participate in the open meeting in Paris last week. I attach our response to the detailed questions posed in the consultation.

Our principle concerns about this consultation are about the narrow focus of much of the paper, in that considerable effort has been put into consideration of inducements in the relatively transparent world of UCITS, with little attempt to shed light on other, more opaque, alternatives.

If this information imbalance is not addressed it is likely that some advisers will favour other products not covered by MiFID, that may pay higher levels of commission and for which the disclosure requirements are less. We assume that it is not an intended consequence that investors end up with products upon which they have less information about costs and inducements, and which may therefore be less suitable and more costly. It is not an argument about reducing or limiting disclosure on UCITS, for example, it is about ensuring that equivalent disclosure is made on other retail products.

[1] IMA members include independent fund managers, together with the asset management arms of banks, life insurers and investment banks, and occupational pension scheme managers. They are responsible for the management of nearly £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pension and life funds), private client accounts and a wide range of pooled investment vehicles. In particular our members manage 99% of UK-authorised investment funds (i.e. authorised unit trusts and open-ended investment companies).

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The introduction of the concept of proportionality appears to move away from the desire to provide the investor with the information necessary to allow them to make decisions for themselves, in this case to decide upon the worth of the service being provided.

Should you wish to discuss any of the points we have raised in further detail please do not hesitate to contact me.

Yours faithfully

Angus Milne
Senior Adviser

Consultation on inducements under MiFID (CESR/06-687)

IMA's response to the specific questions asked in the Consultation Paper.

General explanation and relationship with conflicts of interest

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?*

   We agree, so long as it is accepted that the phrase "in relation to the provision of an investment or ancillary service" should not be interpreted too widely. An investment firm will be paying for equipment, software and other analytical tools, for example, which will be used in the provision of services to all clients, as part of normal business expenditure, which would not generally be regarded as falling within the normal definition of an inducement.

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?*

   We agree with most of your analysis. The implication in paragraph 6 is unfortunate and prejudicial. The presumption is that the receipt of standard commissions or fees acts as a dangerous incentive, while this should instead be regarded as a normal payment for both distribution and/or advice, as recognised in Recital 39. The receipt of non-standard commission may indeed act as an incentive, and so the emphasis in your paper should have more correctly concentrated on this.

   However, we believe that it would be helpful for CESR to clarify the respective regulatory responsibilities for cross-border activities.

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

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"?*

   We agree with CESR's view. Specifically, we agree that standard commissions paid by a product provider to an intermediary firm should be disclosed under Article 26(b).

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"?*

   No other examples have come to mind.

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

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

This does appear to be being drawn too broadly, as commented on above. Paragraph 18 would seem to incorporate all normal business and office expenses – as their absence would reduce the costs of the investment firm, and allow it to charge lower fees. However we assume that this is not your intention, as your example (in para 18) seems to imply that some additional benefit (monetary or otherwise), that is causing an increase in the cost of the service being charged to the client, needs to accrue to the investment firm.

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?*

We agree that recital 39 confirms that the receipt of commission for unbiased advice or recommendation should be regarded as designed to enhance the quality of the service. We also agree that the payment or receipt of standard levels of commission does not (under article 21) give rise to a conflict of interest. We do, however, have concerns about the introduction of the regulatory concept of proportionality of any such payment.

The fact that the receipt of the commission must be disclosed – in its essence and more fully on the client's request – provides the client with the knowledge to enable a judgement to be made. For competent authorities to be in a position to judge whether or not any particular amount is proportionate to the service would be to interpose itself between the investment firm and its client, and to lay itself open to accusations of being a price regulator. It is up to the client to decide upon the value he or she ascribes to the service being provided. We do agree, though, that the firm should have regard for its other obligations – including the obligation not to impair compliance with its duty to act in the best interests of the client – when considering the level or amount of commission it receives. Furthermore, it is only the intermediary (and not the product manufacturer) which can make these judgements.

That this duty should lie with the investment firm actually having contact with the investor is important. A product provider would not be in a position to know the service being provided by the intermediary, nor the overall charge to the investor from any other services being provided. Furthermore, with an increasing proportion of business being conducted via fund platforms, product providers are unaware of the identity of underlying investors.

The emphasis in the examples appears to pre-suppose that the receipt of standard commissions is not to be supported. This runs directly contrary to

Recital 39. Example 1 refers to occasions where the commission is disproportionate to the market, while Example 2 relates to whether the commission is disproportionate to the value of the service.

Example 4 seems to be discouraging the provision of training of advisers by product providers. For good and suitable investment advice it is more important than ever that advisers are well-informed about the products, and understand them – including the technical aspects of them. That the training of such persons seems to be being judged first on the non-monetary benefit seems harsh. Firms should be encouraged to provide good and effective training – while always having regard for and taking into account the potential for conflicts of interest to arise.

However, the main concern about the examples is that is attempts to address, in the main, the relatively straightforward aspects of inducements. It fails to comment on products that are far less transparent, where the benefit may be held within the spread, or within the structure of the product itself. It fails to address the need for effective disclosure of payments made within a group, where there can be significant incentives to sell own-branded products as opposed to other products.

While this is evidently not the purpose of this consultation to suggest other, non-MiFID changes, it would have been encouraging if it had been recognised that there was a need for greater transparency in other products, and that representations would be made to the Commission to address the imbalance, the unlevel playing field.

Article 26(b): disclosure

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?*

   We agree that guidance on the detailed information should not be necessary. However, we consider that CESR should make it clear that, within a group context, all payments should be included in the disclosure. This should include commission equivalent figures, to use the UK terminology.

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 agree with CESR's approach. Within a UCITS environment the charges taken by the product provider are disclosed in the Simplified Prospectus. The UCITS firm itself is outwith the requirements of MiFID, but the

document will be available to clients under both MiFID and UCITS directives. It is the part of those charges that the intermediary receives that should be the subject of the immediate disclosure, so that the client can determine the worth of the service being provided.

Tied agents

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 have no comment on this.

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

    We have no comment on this.

Softing and bundling arrangements

There are several points which the IMA would like to make regarding the text of the CESR consultation in paragraphs 41 – 42.

First, although softing and bundling arrangements look very similar from the perspective of inducements and conflicts of interest, their economic origins are very different. Any analysis of the consequences of regulation needs to take these differences into account in assessing regulatory impact.

- 'Softing' of additional services is a creature of regulation, reflecting in many jurisdictions a hangover in regulation from fixed commissions, but its continuance in a world of individually negotiated commission rates also may represent a market outcome of competition. Where the supplier has high fixed costs, and the value/volume of the services consumed are not predictable or under the control of either party, agreeing a unit price for the service ex ante is subject to a high level of uncertainty. The supplier wants the consumer to agree to a minimum volume at any one particular unit price; the consumer is reluctant to agree because he is uncertain about volumes. One option for resolving this contractually is to agree an ex ante unit price but also agree an ex post adjustment if values/volumes turn out differently i.e. to agree an ex post volume discount. The payment of the discount in the form of services rather than cash is a hangover from fixed commissions: alternative market mechanisms, for example, a multipart tariff, cannot be agreed by the portfolio manager as it potentially would deliver different outcomes to different end investor clients.

- Bundled services may be sold within the bundle because their costs cannot be recovered any other way. The bulk of bundled services provided by a broker to a portfolio manager comprise information – data, advice, and research being the main items. The value of information – and hence what a portfolio manager is prepared to pay to acquire it – depends upon his ability to use it in the market to gain advantage over other managers. The more people

share the information the less value can be extracted from it by any one manager and hence the lower the price that a manager is willing to pay for it. Indeed the market clearing price is likely to be close to zero – hence why information is bundled. In other markets in information, mechanisms are available for protecting its value e.g. patent law. Financial markets are however efficient at capturing information in prices rapidly.

- Information is however very important for liquidity – the less well informed the market in general the more exposed individual traders, and in particular liquidity providers e.g. brokers acting as market makers, are to informed traders and the less likely they will be to supply liquidity. So more research equals more liquidity equals lower spreads. Whereas the economic consequence of too much research being produced is the wasted cost of the excess research, the economic consequences of too little research are greater and more widespread. The IMA commissioned Charles River Associates to conduct research into the Financial Services Authority's proposed changes to the regulation of bundled services and soft commission arrangements in 2003 in order to inform its response to CP176.[2] One of the conclusions of the research was that separate pricing would lead to a disproportionate fall in the consumption of research which would lead to poorer price efficiency and therefore to lower liquidity especially in medium to small stocks. The market detriment is asymmetric as there is little cost to the over-production of research.

Second, whereas the IMA agrees with CESR in paragraph 42 that investment managers may have a conflict of interest in where they decide to place a trade in that they are receiving other benefits on top of the actual execution, we are aware that despite a great deal of research, by the industry and by the FSA in the UK, that there is little evidence of significant disbenefits arising out of these arrangements.

- For example, no evidence of overtrading was found , This is not surprising as commission costs are a very small fraction of total trading costs when taking into account implicit costs such as market impact or unfilled execution. Total trading costs in the UK are typically 100 - 150bp while full service commission rates average around 10bp. Given that a fund manager is endeavouring to produce the best possible net performance for his client and is judged (including hired and fired) on that basis, there is no incentive for him to incur trading costs of 150bp for benefits which cost merely 2 - 5bp i.e. the average difference between execution only and the full service commission rates which purchases services other than execution.

- The research did identify a few small pockets within the overall market where portfolio managers felt that broker choice was restricted and where the ability to separate the research provider from the provider of execution would be beneficial to a better outcome for clients. Commission Sharing Arrangements were seen as one way of achieving this.

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[2] An assessment of the proposed changes to bundled brokerage and soft commission arrangements – Charles River Associates October 2003.
http://www.investmentuk.org/news/research/2004/topic/soft_commissions/craresearchcp176.pdf

- The research also distinguished between overproduction of information and research and overconsumption. The evidence pointed to some overproduction but not to overconsumption.

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

    FSA regulation (FSA Handbook COB 7.18) on UK firms already requires portfolio managers to make full disclosure to clients of services received that are paid for out of trading commissions and fees. The regulations also set out the criteria that must be met for an additional service to be paid for out of commission. These rules have been in place since [date]. The disclosure to end investors provides a full breakdown of how commission spend is generated from the pattern of trading, both by market counterparty and by nature of the trade thus allowing end investors to see if there are undue distortions to where trades are placed and challenge the portfolio manager about them. A disaggregation of the services paid for out of commissions is also provided as part of the disclosure, thus permitting end investors to challenge the value to them of the services being acquired on their behalf.[3]

    The IMA believes that the requirements of Article 26 in respect of bundled and softed services are as set out above being fully met within the UK jurisdiction and therefore that Article 26 will have no additional material impact on its members.

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

    The IMA believes that the application of common principles across the EU regulators with respect to softing and bundling arrangements could be helpful, provided that the common approach restricts its focus to disclosure as per Article 26 (b), and resists any further detailed prescription. As the UK experience is revealing, an overly detailed approach can distort the market to the disbenefit of end investors, for example were it to inadvertently stifle innovation in trading arrangements (for example if the detailed rules were not technology neutral).

    Given the role of the EU as a global centre for asset management, it will also be important that any common approach does not introduce significant inconsistencies with US market practices which might require portfolio management firms to fragment their trading and so lead to higher costs to end investors.

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[3] IMA Pension Fund Disclosure Code, Second Edition March 2005 provides a full description of what is currently provided to institutional clients of UK portfolio managers. http://www.investmentuk.org/news/standards/pfdc2.pdf

Of particular importance are Commission Sharing Arrangements which permit research and execution services to be purchased from more than one source out of a single commission payment. This increases competition in both execution and research services.

13. *Would it be helpful for CESR to develop that common approach?*

The IMA believes that local regulators are best placed to implement those principles which should not be overly prescriptive. Prescription stifles competition and innovation and discriminates between different methods of delivery of the same service. Any regulation should be technology neutral.

Should CESR wish to develop further a common approach we would caution that it should be evidenced based, and that any proposals should be subject to rigorous regulatory impact analysis including an open and transparent process of consultation with market participants.

Q9: Do you agree with the broad evaluation and conclusions as outlined in paragraphs 50-55 above? What does your own evaluation suggest? What evidence base can you provide to support your conclusions?

Two blank tables are provided at Annexes 3(i) and 3(ii) for respondents to use to create their own 'tick lists' to help formulate their own evaluation. CESR would welcome completed copies together with supporting analysis as part of any feedback to this consultation.

While recognising the value of Annex 3(i) for individual firms, there is a tension between what is the best solution for an individual firm, in terms of flexibility and tailoring the regulation of a branch to its particular situation, and what is best for the industry (and consequently the consumer), in having consistency – and certainty - of approach by regulators.

Q10: In the absence of a single public registry of tied agents, how might Member states enhance co-operation for the benefit of clients?

No comment (this is outside IMA's remit).

Q11: Do you agree that there is a need for co-operation between competent authorities to help ensure that the requirements for good repute and possession of knowledge for tied agents can be met in practice? Do you agree that prior to registration the home Member State should be able to exchange information with the competent authority of the Member State where a tied agent is located to help establish that he has the required good repute and knowledge? Would any specific guidelines be helpful; if so, what are your suggestions?

No comment (this is outside IMA's remit).

Q12: To help resolve the practical questions on the supervision of tied agents, good co-operation between regulators will be necessary. CESR is minded to conduct further work in this area. Do you have any practical suggestions or comments that could help CESR fine-tune its approach for tied agents?

No comment (this is outside IMA's remit).

Q13: Do you agree that a common approach on deciding what constitutes passporting for an MTF, as referred to in Article 31 (5) and (6) MiFID, by all CESR members will benefit investors and industry?

As long as there is consistency and clarity then IMA has no comment to make on how this is achieved.

Q14: Do you agree with the suggested criterion ("connectivity test") for deciding whether an MITF is passporting its services/activities? If not, should the criterion be adjusted or replaced or elaborated on more and for which reasons?

As long as there is consistency and clarity then IMA has no comment to make on how this is achieved.

Q15: Do you agree with the arguments set out in this chapter?

We do agree with the argument that, where an investment firm establishes an office of the same legal entity in another Member State solely for promotional purposes, that office should not be qualified as a branch under MiFID.

Q16: Do you agree with the proposal of mapping ISD to MiFID proposed in Annex 1? What changes or possible alternatives would you suggest?

We do agree with CESR's proposal that all ISD passports should automatically be mapped across to the MiFID regime.

Q17: Do you consider the suggested approach appropriate and/or do you see other issues that should be handled in this protocol?

This seems reasonable. The only additional item that we would like to be included is a timescale for regulators to decide between themselves how to regulate a branch over which they both have some jurisdiction.