**International Swaps and Derivatives Association (ISDA)**
**International Capital Market Association (ICMA)**
**Asociación de Mercados Financieros (AMF)**
**Association of Private Client Investment Managers and Stockbrokers (APCIMS)**
**Association of Foreign Banks (AFB)**
**Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. (BWF)**
**Danish Securities Dealers Association (DSDA)**
**Euribor ACI European Commission Working Group**
**Finnish Association of Securities Dealers (FASD)**
**Futures and Options Association (FOA)**
**Icelandic Financial Services Association (IFSA)**
**Norwegian Securities Dealers Association (NSDA)**
**London Investment Banking Association (LIBA)**
**Securities Industry and Financial Markets Association (SIFMA)**
**Swedish Securities Dealers Association (SSDA)**

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**27th April.2007**

## Response to CESR's second consultation on Inducements under MIFID (07-228)

The Associations welcome the opportunity CESR has provided to comment further on its draft recommendations for inducements under MIFID (CESR/07-228), following its previous consultation in December 2006 (CESR/06-687).

General comments on CESR's second consultation in the light of our key points on CESR's first consultation

We are disappointed at the outcome of CESR's first consultation. CESR says that it has taken into account the views of respondents, but has not at this stage provided detailed feedback which would enable respondents to understand its reasoning. On page 6, CESR comments that "it has considered [respondents'] comments very carefully…However, CESR has concluded that the interpretation of Article 26 that it adopted in its consultation paper is correct". On page 5, CESR states that "the Commission agrees with the legal interpretation given by CESR. Furthermore the Commission considers that the contents of this paper do not go beyond the MIFID legal texts and that the approach taken in this paper comes from the normal, natural reading of MIFID and the Level 2 Directive". It would have helped the process of consultation, in line with the 'better regulation' principle, to be able to understand more clearly the reasoning behind CESR's conclusion.

The conclusion that CESR has come to, and that it says the Commission agrees with, that the scope of Article 26 goes beyond "inducements" as normally understood, raises important questions about the interpretative status of headings and recitals in EU legislation. We would have expected that the clear reference in the heading of Article 26 and in Recitals 39 and 40 to "inducements" should have had a strong influence on the interpretation of these provisions. It is also important to take account of the fact that Article 21(e) of the Level 2 Directive specifically excludes standard commissions and fees from the concept of an "inducement".

In considering our response, CESR should take into account the fact that we still disagree with CESR's basic interpretation of the scope of Article 26.

We also have the following general comments on the second consultation:

We remain concerned that some of the draft recommendations to competent authorities as worded could be not merely an aid to supervisory convergence, but go beyond what MIFID requires since they are phrased as if they were additional expectations on firms which are not provided for in the Directive. CESR says in the Foreword that its recommendations are intended to be applied to CESR Members on a voluntary basis in their day to day regulatory practices to assist supervisory convergence. It states that they do not constitute EU legislation and will not require national legislative action. However, some of the recommendations, in particular Recommendations 4 and 6, are phrased as expectations on firms in a way that could, as we explain in more detail below, in effect amount to additional rules or requirements. Given the status which CESR says that the recommendations have, and CESR's role at Level 3 of the Lamfalussy process, it is essential that the recommendations do not effectively impose binding requirements which are additional to the Directive.

We continue to stress the importance of focusing the controls of Level 2 Directive Article 26(b) on circumstances where payments induce firms to act in a way that is inconsistent with clients' interests, as this mischief is inherent in the concept of a prohibited "inducement". It will be very important for CESR's recommendations to be aligned with this priority. It would not proportionate to take as a starting point a presumption that all payments are prohibited unless proved otherwise, when most are perfectly legitimate payments for services provided. We are concerned that CESR's draft recommendations would do so: by stating that Articles 26(a) and (c) provide exemptions from the requirements of Article 26(b) (whereas in fact, Articles 26(a), (b), and (c) are each independent exemptions from the Article's restrictions); by reducing unnaturally the scope of payments which fall under Articles 26(a) and 26(c), thereby pushing into Article 26(b) payments which should either not be treated as inducements at all or fall into Article 26(a) and 26(c). Those attending the Open Hearing in Paris on 24th April emphasised this point at some length. At this late stage, it is also important for CESR not to seek to impose new controls that would require firms to make system changes that would divert resources away from other urgent MIFID implementation tasks.

Detailed comments on CESR's draft recommendations

*Q1: Do you have any comments on the content of the draft recommendations?*

We have the following detailed comments on CESR's draft recommendations:

*Recommendation 1*

Recommendation 1(a) states that Article 26 applies to 'commissions and fees that may be paid or provided to or by an investment firm and which are standard in the market'. As described in our comments on paragraph 10 below, this assertion is inconsistent with Article 21(e) of the MIFID Level 2 Directive, which is clear that such commissions and fees are **not** inducements. Recommendation 1(a) should therefore

not state that Article 26 applies to fees and commissions which are standard in the market.

*Recommendation 2*

In both Paragraph 6 and Recommendation 2 (and also in the extracts from the MIFID Implementing Directive on page 18) CESR incorrectly transposes the EU legal text by inserting the word "acting". The Article 26(a) exemption applies to payments made "to or by the client or a person on behalf of the client", not "to or by the client or a person acting on behalf of the client". Introducing the word "acting" would inappropriately narrow the scope of Article 26(a) by inserting additional conditions which also seem to be reflected in the final sentence of Recommendation 2. CESR states that 'it will also be relevant whether the client has issued a specific instruction to the investment firm and has the power to vary the arrangement without reference to the investment firm". While this issue may be relevant, it is important that it is not seen as determinative (and it is important to take account of the fact, for example, that it is often the case that fund managers often make investment decisions and payment instructions on behalf of the funds which are their clients without direct referral to those clients). There will be many other circumstances in which a payment is made by or to a person on behalf of the client, in addition to those which CESR describes in the last sentence of Recommendation 2.

As noted in our general comments above, in paragraphs 7 and 9 CESR concludes that Articles 26(a) and 26(c) respectively provide exemptions from Article 26(b). We think this juxtaposition is wrong because (a), (b), and (c) deal with payments of different types, (a) from or to the client or person on the client's behalf, (b) from or to a third party, and (c) proper fees paid by or to the firm itself. All three types of payment are, independently, exempted from the Article 26 proscription. See also our comments on paragraph 16.

*Recommendation 3*

In Paragraph 10 CESR states that "The possibility of a receipt of a **standard** commission or fee is of a nature to give rise to such a conflict [with the firm's duty to act honestly, fairly, and professionally in accordance with the best interests of the client]." We think it is not correct to say that any standard commission or fee is of a nature to give rise to a conflict. Standard commissions and fees which are paid to a third party in order for the third party to provide a service that is necessary to complete the deal, rather than as an incentive provided to a broker, for example, by a product provider to sell his products, do not give rise to any conflict whatsoever. They are simply a payment for services. The concern CESR expresses about an incentive for a firm to favour one product provider over another because of differences in the commission that it receives is a legitimate one (and should be considered under Article 26(b)), as is a concern that a firm might overtrade for the sake of maximising commission (though the latter should be governed by the general duty to act fairly and professionally, or by a specific anti-churning and suitability rules). However, there are many other circumstances in which the receipt of a standard commission or fee does not give rise to a conflict, and Article 26(c) should not be interpreted artificially narrowly to broaden the range of controlled inducements that are subject to Article 26(b). It is important to bear in mind in this context that

Article 21(e) of the Level 2 Directive is not consistent with CESR's statement that a standard commission or fee is of a nature to give rise to a conflict. In specifying minimum criteria for determining whether a conflict arises whose existence may damage the interests of a client, Article 21(e) cites: "whether the firm…receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service". Recital 24 of the Level 2 Directive further states that "It is not enough [for there to be a conflict of interest] that the firm may gain a benefit if there is not also a possible disadvantage to the client".

*Recommendation 4*

In Recommendation 4(b), we welcome the fact that CESR has recognised that the benefit according to which a payment can be designed to enhance the quality of the service can be measured "at the level of the service to the relevant client group", and in Paragraph 14 that "such payments may also benefit other clients or groups of clients apart from the particular client that is receiving the investment service", and therefore need not be measured at the level of the particular service to the particular client. In line with CESR's analysis in Paragraph 14, it is important that the "relevant client group" in Recommendation 4(b) means the generality of clients to whom the relevant service is provided, and not necessarily in relation to a particular business line, as part of Paragraph 14 seems to imply.

Also in paragraph 14, we agree with CESR's interpretation that a judgement about whether a payment is designed to enhance the quality of the relevant service can be made at the time the arrangement is proposed, and that there is therefore no need to demonstrate retrospectively that a payment has actually enhanced the service.

In paragraph 16 and point (a) of Recommendation 4, it is important to be clear that the 'designed to enhance the quality' test applies only to arrangements which are subject to Article 26(b), and not as a general test that applies to Article 26 as a whole.

In point (b) of Recommendation 4, it is important to be clear that a benefit need not be quantifiable for a payment to be designed to enhance the quality of the service; that the judgement can be a qualitative one, and that the ability to provide the service at all may represent an enhancement of its quality.

CESR states in paragraph 17 that the factors in Recommendation 4 are 'indicative criteria only, and not strict or exhaustive factors that must be taken into account in all cases. They are not standalone obligations or new requirements'. In paragraph 16, CESR states that 'the factors do not represent a 'one size fits all approach' and are not intended to apply uniformly to all situations. We very much agree with this approach, which we think it is essential for CESR to follow, but we are concerned that in some respects the text of Recommendation 4 itself is phrased more as an instruction to firms about strict factors that they **should** take into account ("among the factors that a firm **should** consider…are the following") rather than as a recommendation to competent authorities. It is of course important that Recommendation 4 does not imply new obligations or expectations that are not in the legislation. We think that it is important that Recommendation 4 should at least be rephrased so that it is clear that it is a recommendation to CESR members, not a statement of requirements on firms, for

example along such lines as: "CESR considers that among the factors that may determine that a payment is designed to enhance the quality…… are the following". Points (a) to (e) also need to be rephrased in certain respects to reflect the fact that this is a non-exhaustive list of factors that may be taken into account.

We consider that an additional factor that firms should be able to take into account is whether or not the firm has taken steps to manage the relevant conflict.

*Recommendation 5*

Under paragraph 18, it is important to note that there may be many other product providers beside management companies of collective investment schemes.

Paragraph 19 and Recommendation 5 both refer to Level 2 Directive Recital 39. That recital only talks about advice based services and does not cover non-advice services. However we believe that CESR draws the correct conclusion that payments in connection with non-advice based services should also be allowed if they meet the requisites of Article 26 (and this conclusion derives of course from Article 26 itself, and not Recital 39).

*Recommendation 6*

In Paragraph 23 CESR states the existence of disclosure obligations for each firm in a chain of intermediaries in relation to their own clients for all intermediaries in a chain that provides a service to a client. It is of course important to recognise that when chains include eligible counterparties, firms that provide services to eligible counterparties will not be subject to Level 2 Directive Article 26.

Recommendation 6, like Recommendation 4, is phrased in some respects more as an instruction to firms rather than a recommendation to competent authorities: "in order to contain the 'essential terms', a summary disclosure **must** provide adequate information…"; "…a generic disclosure…**is not sufficient**… and **will therefore not be considered**…". We think that it is important that Recommendation 6 should be rephrased so that it is clear that it is a recommendation to CESR members, not a statement of requirements on firms.

Detailed comments on CESR's examples

*Question 2: Will the examples prove helpful in determining how Article 26 applies in practice? What other examples should be covered or omitted?*

*Question 3: Do you have any comments on the analysis of the examples?*

Example IV: We agree that factors 4(a), (b), and (c) would be relevant in the circumstances described. CESR states that "any enhancement of the investment service provided to the firm's clients seems unlikely", but it would be important to take an objective and rounded view of the enhancement of service that the arrangement might give rise to (for example as part of a more general reduction in dealing fees). It is also important to be clear that from the point of view of the broker,

the payment is made to the portfolio manager, which is its client, and therefore that the payment falls under Article 26(a).

Example V: As in the case of example IV, it would be important to take an objective and rounded view of the enhancement test. We think that CESR should not prejudge the issue by using the weighted language "such arrangements are not altogether prohibited" and "it would be difficult…to meet the other conditions". Example V is in many ways analogous to Example VII; Example VII rightly takes account of Recital 39 and Article 26 (b), but it is also important not to apply a much stricter standard to Example V.

Example VIII: As in the case of Examples IV and V, it would be important to take an objective and rounded view of the enhancement test. CESR states that "it is doubtful that Article 26(b) can be satisfied", but it would be important to take an objective and rounded view of the enhancement of service that the arrangement might give rise to (for example as part of a more general reduction in dealing fees).

Examples XI and XII: The last two examples are not necessarily linked to the issue of inducements as long as the client is not affected. Training should only be considered as falling within Article 26(b) if it is provided in association with such benefits (e.g. foreign travel) as might reasonably be assumed to influence the recipient's placing of future business. We agree with CESR that equipment that is closely related to services provided to clients should be likely to be permitted. In Example XII, it is important to be clear that from the point of view of the broker, the benefit is provided to the portfolio manager, which is its client, and therefore that it falls under Article 26(a), even if, for example, the fund manager instructs the broker to use a portion of the commissions generated from its orders to pay for services that are provided by a third party to the fund manager.