

**CESR'S CONSULTATION 09-958:
INDUCEMENTS: GOOD AND POOR PRACTICES**

Response of the AMAFI

1. AMAFI thanks CESR for providing it with the opportunity to discuss its suggested good and poor practices in respect of the inducements rules set by MiFID.

2. AMAFI welcomes CESR's initiative on an issue that is particularly important to firms because it is complex to implement. Investment firms with activities on the wholesale markets, which constitute most of AMAFI's membership, have now translated the rules into their internal policies and adapted them to their various businesses.

There is still a feeling though that practices differ among them both at a national and European level for various reasons linked notably to the variety of roles they may play in the product chain, the different nature of intermediaries involved in delivering a product or in a client's relationship and the differences in the regulators' interpretations of the same situations. This lead to a sense of complexity, which CESR's document illustrates well, as most of the time a case by case analysis is required to assess the fee's legitimacy with regard to the rules and the treatment is should be subject to.

3. Hence, the various points of interest identified by CESR's paper are undoubtedly of value to the AMAFI who wishes to make the general observations set out below (I) and provide some specific comments on the questions raised by CESR (II).



I. – General Observations

4. As a preamble, AMAFI regrets that the time allowed to respond to the consultation was not set to the three-month standard applicable to significant issues (see CESR's consultation policy – CESR/01-009). This is especially so on the counts that:

- The end of year is usually busy, which is especially the case this year both at the national and international levels considering the number of issues being addressed at the moment in our industry; and
- The rules on Inducements are difficult to interpret and implement in the EU, with various regulators focusing on different situations and a need for a more harmonised approach. CESR started its work on the subject (via its questionnaire) at the end of 2008, allowing for itself time for much needed discussions at the expense of the time left to market participants to comment.

A longer response time would have allowed for a more thorough examination of the questions raised and a better argued response from the AMAFI.

➤ ***The strict enforcement of the rules on inducements should be weighted against clients' needs and expectations***

5. The rules on Inducements hinge upon the principle that transparency on fees and commissions is necessarily in the client's interest. Undoubtedly, these rules are a way to ensure that an investment service is provided in the best interest of the client and not because the provider has, for instance, a financial interest in selling one product instead of another one that would have been more suitable to the client. This objective is not disputable.

However, it could be worth examining further the link that could exist between transparency and the ability of all types of clients to have access to financial market services in the long term. The lack of transparency is also a way to pool and share certain costs among different types of clients; it is also a way to make acceptable to the client the price of a service. Some may consider that these reasons are not justified: on the one hand, there is no reason for some clients to pay for a service provided to others, on the other hand, a client should always pay the real price of the service he/she receives.

There is however a practical truth attached to it and the current trend of enforcing the rules on inducements in a strict and all encompassing manner runs against it. Such a trend will lead to an increase in the price paid by some clients, mainly retail ones, to get access to some investment services, yet these clients are probably not ready to pay for the full price of those services.

This is an issue, important and complex, which should in AMAFI's opinion be considered carefully by CESR.

6. One of the main subjects the rules on inducements are targeting is the distribution of financial products. In this respect, there are a number of distribution platforms that are established outside of the European Union, which are successful at distributing their products to certain segments of European clients.

This trend is being exacerbated at the moment, as reported in the press, with a number of firms relocating or developing their business in Switzerland. Although no rule on inducements applies there, clients do not seem to be discontent and continue to deal with these platforms.

The purpose here is not to discuss the legitimacy of the rules on inducements, whose principles are fair and certainly beneficial to clients in encouraging proper behaviour from firms. However this example illustrates the discrepancy between the growing importance attached to the inducements rules in the EU and the value clients give to it. AMAFI believes that this is an observation that CESR cannot fail to consider and examine further when trying to set up benchmarks on this issue.

II. – Specific observations

7. On a purely formal note, one could note that the term “payment” is sometimes used with the meaning of payments and non monetary benefits (for e.g. in the last paragraph of page 3, in question VIII and X, etc.). To make sure there is no confusion, a definition should be provided at the start of CESR’s document or, preferably, the terms “payments and non monetary benefits” should be used throughout the document.

➤ *Classifying payments and non-monetary benefits and setting up an organisation to be compliant*

8. As a preamble, AMAFI wishes to stress that it is up to each firm to set up arrangements and procedures to meet its regulatory obligations, which are proportionate to its organisation, the nature of its businesses and its size. CESR should therefore provide for some flexibility and refrain from prescribing standard arrangements that may constitute an appropriate solution for some firms but not for others. This is especially so with regard to questions II and III.

▪ Question I: Do you agree with CESR’s views about the arrangements and procedures an investment firm should set up?

9. AMAFI agrees that, as a general objective, firms should set up policies and procedures to ensure the payments and non monetary benefits they pay and receive are appropriately classified and to prevent those that are in breach of article 26. Firms should ensure that all types of situations involving payments or non monetary benefits have been identified and a standard policy set for each type. They should then get organised to ensure that these standards are properly applied.

Contrary to the statement made in § 36, this does not necessarily require an evaluation of each new contract and relationship. Rather, this could be done by making sure first, that each new contract or relationships follows the standards set and second, that any situation of a new type (i.e. involving a structure of payments or non monetary benefits that has not been identified previously) is properly assessed and, if relevant, a standard is set for it. There are several ways in which firms can meet this objective.

10. CESR makes a distinction between the classification (first step of the process) and the evaluation of the payment or non monetary benefit (second step of the process) – see in particular example 1 of poor practices p. 14 of CESR’s document. In AMAFI’s opinion, this process is not correct conceptually since the classification is inseparable with the evaluation. A payment or non monetary benefit to or from a third party could be classified either as a proper fee or as one authorised subject to certain cumulative conditions: the decision to classify it in the first group or the second relies exclusively on the evaluation.

Hence, the process should rather be to (1) identify, then analyse (2), and classify (3) and if necessary assess under which conditions any other payment could be authorised.

- **Question II: Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?**

11. The compliance function is responsible for controlling and assessing the appropriateness and the efficiency of the policies, procedures and measures taken by the firm to comply with its regulatory obligations. Within this remit fall obviously the inducements rules, as they are part of the rules of conduct set by MiFID. There is therefore in AMAFI's view no need to set up specific responsibilities in respect of these rules, as these responsibilities exist already.

Firms should rather make sure they have incorporated the inducements rules in their compliance monitoring programme to ensure specific procedures exist and they are abided by.

- **Question III: What are your comments about CESR's views that at least the general approach the investment firm is going to undertake regarding inducements (its 'inducements policy') should be approved by senior management?**

12. Senior management is responsible for ensuring that rules and regulations to which the firm is subject are implemented and abided by. This is a general obligation that is strong and all-encompassing and that allows for sanctions if the firm were to be in breach of one of these provisions. Senior management ensures that there are people in the firm who are in charge of the implementation of its regulatory obligations and who have its full support to do so.

In AMAFI's view, there is no reason for the senior management to consider that with respect to inducements, those responsible could not be relied upon to carry out their function properly. There is therefore no need for senior management to be involved in the detail of the implementation of the inducements rules, especially since it should be able to focus on the most critical aspects of the business and not be dragged into the specifics of each regulatory obligation. If employees in charge are properly empowered by senior management, the firm as a whole should be able to adapt itself to a new regulatory obligation without the involvement of senior management.

13. However, it is critical in AMAFI's view that senior management be notified and be in a position to decide when a conflict arises with the business in implementing the rules. This is far more important than approving the firm's general approach to inducements, whose approval should be subject to the standard approval process within the firm.

➤ *Proper fees*

- **Question IV: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?**

14. Yes AMAFI agrees.

- **Question V: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?**

15. Yes AMAFI agrees.

- **Question VI: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?**

16. This is a difficult question that requires a thorough examination, which AMAFI has not been able to carry out given the time allowed for the response. We therefore ask CESR to reconsider this issue and deal with it at a future time, after detailed examination and discussions with the firms.

- **Other comments**

17. AMAFI agrees with § 48 of CESR's documents that when a firm is not selling/placing the financial instruments issued and is only performing all or part of the underwriting to the issuer, the underwriting fee will generally fall within article 26 (a) of the Level 2 Directive.

However, the all encompassing statement that selling/placing financial instruments when also acting as an underwriter would generally fall within Article 26 (b) needs qualifying. The selling and placing of financial instruments while participating in an underwriting can cover very different situations in terms of types of clients, investment services involved and financial instruments concerned. Such a general statement does not consider the variety of these situations, which can yet lead to very different conclusions.

AMAFI has worked on this particular issue with its members in 2008 and has started some discussions at the national level with the regulator. It therefore suggests that further consideration be given by CESR to the issue and that a thorough examination be made before defining a benchmark. AMAFI therefore requests that this statement be removed from the paper for the moment.

Some of the elements that AMAFI has considered in its analysis and that CESR may find useful in its examination of the issue are the following:

- Distinguishing the various types of issuance depending on their objective (meeting the financing needs of the issuer versus the investment needs of the investors)
- Whether or not the cost of the payments is born by the investors or by the issuer
- The various components of the payment (lead manager fees, arrangement fees, management fees, placement fees) which may not be explicit
- The type of investors involved - wholesale or retail clients - and the investment service provided to the investor (investment advice or not)
- The legal framework under which the issuance occurs (for e.g. the Prospectus Directive) and the disclosures already attached to it

18. As regards intra group payments and non monetary benefits (§ 53 and § 83 of CESR's document), CESR has already made clear in the past its position that they fall within the scope of the inducement rules and it reiterates this position hereby.

This position appears fair and legitimate as it contributes to the creation of a level playing field between large firms with several legal entities conducting different businesses and smaller independent ones.

Without it, the latter may have to disclose to their clients payments and non monetary benefits received from or paid to third parties, whereas large firms faced with a similar situation would not have to do so when the “third parties” would happen to be within their group.

But this issue is multi-faceted and needs to be analysed further considering situations where a firm is organised with no separate legal entities, but still has various different businesses working together. As this situation is not caught within the scope of the inducements rules, and this would not be feasible in any case, the level playing field continues to be distorted.

CESR should not therefore consider that distinguishing between intra-group payments and non monetary benefits and external payments is sufficient to resolve this issue.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the service provided to the client

- **Question VII: Do you agree with CESR's view that in the case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?**

19. AMAFI thinks that this statement should be qualified. It could actually be a better practice from a risk management point of view for a firm to pay an introducer (a service of a one-off nature) over a period of time in order to link the payment or non monetary benefit to the duration of the instrument the client has invested in or to the stability of the relationships introduced or of the flow of the business collected as a result. Such practice allows for a longer term view of the relationships with the third party and the client.

- **Question VIII: Do you have any comments regarding CESR's view that measures such as an effective compliance function should be backed up with appropriate monitoring and controls to deal with the specific conflicts that payments and non-monetary benefits provided or received by an investment firm can give rise to?**

20. AMAFI absolutely agrees that there should be controls and monitoring to deal specifically with conflicts that payments and non monetary benefits can give rise to. However, AMAFI does not agree with the statement that implies that control and monitoring pertain only to the compliance function.

Obviously, the compliance function is an integral part of the control systems of the firm: one aspect of its duty is indeed to monitor and control adherence to the rules applicable to the firm (see above § 11).

However the firm's control system does not rest uniquely on the compliance function, which constitutes one level of control, the others being the business itself, the permanent control function and the audit department. With regard to the inducements rules, the business itself has an important role to play in ensuring that the segregation of tasks is respected, the amounts disclosed in the client's documentation are correct, the standards set are used properly, etc... In terms of monitoring, the permanent control function is key, together with the compliance function. Finally, the compliance function is also instrumental in other aspects of its role not related to controls, like helping to resolve conflicts arisen by payments and non monetary benefits and in advising the business.

CESR's statement should therefore be amended not to target specifically the compliance function, but rather the firm as a whole.

- **Question IX: What are your comments on CESR's view that product distribution and order handling services (mentioned in §74) are two highly important instances where payments and non-monetary benefits provided or received can give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?**

21. AMAFI agrees that product distribution in the context of investment advice and order handling in the context of portfolio management as described in § 74 of CESR's document pose a greater risk of conflicts between the duty to act in the best interest of the client and the incentive to generate higher revenue. However, there are two important caveats to consider:

- This statement applies only to the specific situations described and not to all situations of product distribution or order handling services.
- A regulator should not assume, when faced with such cases, that the firm is in breach of its duty in relation to the inducement rules. The procedures and monitoring implemented by the firm to mitigate this risk are paramount to assessing the situation.

- **Question X: What are your comments on CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?**

22. This may not be sufficient, however it may constitute one of the arguments justifying the increased quality of the service provided, especially so since this criterion, as highlighted by CESR, is very difficult to assess. As mentioned in § 5 above, the fact that the client is not being charged directly for this cost but rather that the cost is pooled and shared, brings about some benefits. In particular, one of these benefits is an access to some investment services that are made less costly for some clients and which would otherwise be closed to them.

23. On the more general subject of assessing when the quality of the service is enhanced by the design of a payment or a non monetary benefit, CESR lists some examples of justification provided by firms and identifies a few that it does not consider as appropriate. However, it does not provide examples of justifications that it considers proper, which would be of great benefit to firms.

➤ ***Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure***

- **Question XI: Do you have any comments on CESR's view of the summary disclosure rule under Article 26(b)(i) of the Level 2 Directive (including when such a disclosure should be made)?**

24. Another form of disclosure could be an average of the fees received (or paid). This is especially relevant when, for the same transaction, there are several third parties involved with different fee schedules.

AMAFI believes that the information provided in the disclosure should depend on the investor's type it is destined to. For example, clients of the wholesale markets who are professionals of the financial markets or are categorised as professionals under MiFID do not need the same level of detail as retail clients. Also, the responsibilities of the product providers with respect of the product distributor should be clearly set both in terms of the disclosure itself to the client and in terms of the media used to make this disclosure.

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

25. AMAFI agrees with this statement.

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

26. AMAFI has no comment.

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

27. CESR's position should not prevent firms from using different types of documents depending on their various businesses and their various client types. It is most important on this matter that disclosure should be fair, clear and not misleading, but less important to consider the medium under which this disclosure should be made on which firms should have flexibility.

As an example, AMAFI would like to add that marketing documentation, although rarely, is sometimes used as a medium of disclosure.

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

28. AMAFI fully agrees with this statement.

