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Mr Fabrice Demarigny
The Committee of European Securities Regulators
11-13 Avenue de Friedland
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Response to CESR's Consultation Paper Ref: CESR/06-687
Inducements under MiFID

Dear Sir,

Members of the Irish Association of Investment Managers ("IAIM") greatly value their dialogue with regulatory authorities and believe that this is an essential, mutually beneficial, part of the regulatory process. We therefore welcome the opportunity to respond to CESR's public consultation on inducements under MiFID (CESR/06-687) and trust that our perspective will be of interest to CESR.

Our submission consists of:

- This letter, which initially provides a summary of our views, followed by further detail in relation to the aspects that we consider of particular importance.

- The attached Appendix, which contains responses to the specific questions contained in CESR's CP.

Summary and Overview

The IAIM recognises the necessity for individual firms and industry to identify and manage conflicts of interest in an effective manner and therefore endorses the provisions of Article 19 (1) of the Level 1 Directive and Article 21 of the Level 2 Directive. Furthermore, we recognise the need to ensure that appropriate mechanisms are put in place to prevent firms and third parties from being induced to act other than in the best interests of clients and are of the view that the provisions of Article 26, together with the

provisions referred to above provide an ample regulatory framework within which to manage these risks.

However, while we are in agreement with much of the CP, we are of the view that CESR appears to be extending the scope of these provisions in a manner that is unnecessary, was not envisaged at the time the Directives were agreed and could have unforeseen negative consequences for market completeness, innovation and competition. Furthermore, we could envisage that, though well meaning, the implementation of CESR proposals may actually act to increase costs for investors. We also believe that the excessive focus on particular examples that are (often incorrectly) implied to involve "inducements", instead of a more principles-based focus on the management of conflicts of interest, could negatively impact upon investor protection.

Aspects of Particular Importance

1. Scope:

The IAIM is of the view that the CESR CP outlines a perspective on inducements that exceeds the scope and application envisaged by the Directives. In this regard, it would appear that CESR is of the view that essentially any third party payment or non-monetary benefit is effectively an "inducement". The scope of this interpretation is, in our view, both excessively broad and unnecessary, and largely rooted in the fact that no definition of the term "inducement" is contained in either Level 1 or 2 Directives. Furthermore, any undiluted implementation of this view in the form of regulatory recommendations would have the effect of rendering many sound market practices non-compliant and would have a number of effects contrary to the intention of MiFID including increased costs for investors and reduced market efficiency.

We believe that, in broadening the scope of what constitutes an "inducement", CESR has not taken due account of the interrelationship between Article 26 and other provisions of the Level 1 and 2 Directives. We would make the following specific points in this regard:

- The dependence of Article 26 upon Article 19 (1) of the Level 1 Directive is not adequately recognised in our view. The latter Article requires firms to act "honestly, fairly and professionally in accordance with the best interests of its clients". As Article 26 is aimed at securing the same outcome, the regulatory prohibitions and restrictions that it envisages should only therefore arise to the extent that, in relation to a particular fee, commission and non-monetary benefit, that a firm is acting dishonestly, unfairly or unprofessionally and therefore contrary to the best interests of clients.

- Recital 40 of the Level 2 Directive refers to firms being permitted to give/receive certain "inducements" subject to specific conditions, including disclosure. We are of the view that this recital rightly envisages that there is a distinction between those arrangements involving fees, commissions and benefits that are essentially remunerative in nature and entirely proper and those "inducements" that involve impropriety, and

which should rightly be prohibited or restricted. We believe that the CP does not adequately recognise this distinction.

- MiFID contains a number of provisions, e.g. Article 21 of the Level 2 Directive, requiring firms to identify and manage conflicts of interests. We do not believe that the CP takes sufficient cognisance of the fact that firms will be required to implement effective conflicts of interest measures.

2. Level Playing Field:

While IAIM members are engaged in a broad range of investment activities and are by no means exclusively focussed on the management and operation of UCITS funds, we could nonetheless have a significant concern over the reference of each example in the CP to the operation of UCITS. In this regard, it is likely that many readers will take inference from the CP, which may have been unintended on the part of CESR, that there is something inherently improper about the distribution and remuneration arrangements pertaining in the UCITS industry. As UCITS funds are amongst the most transparent and highly regulated investment vehicles, we would take issue with any such inference.

Furthermore, we would emphasise that the underlying MiFID objectives of market completeness and investor protection may not be well served if CESR follows through on some of its proposals. In the first instance, any proposal to restrict distribution and charging arrangements will act as a force against market completeness. Having regard to investor protection, we could envisage that prohibitions and restrictions in relation to distribution and charging arrangements for certain transparent products could result in the move by investors into differently structured instruments with analogous investment characteristics e.g. certificates and unit-linked policies, the distribution of which is not regulated by MiFID. To the extent that the remuneration arrangements applying to these structures is less transparent than those regulated under MiFID, we could envisage that investor protection could then be weakened.

3. Assumptions In Relation To What Constitutes "Inducements":

The CESR CP appears to be based upon assumptions that are not evident in the Directives. In this regard, the CP appears to assume that all fees, commissions and non-monetary benefits are effectively "inducements", a view that is inaccurate and not founded in the Directives. Our view is that, if the intent of the Directive was to have introduced the regulatory prohibitions that the CP proposes, Article 26 would have been entitled "Fees, Commissions and Non-Monetary Benefits" instead of "Inducements". The term "Inducements" evokes images of enticements to engage in impropriety. It seems to us that any fee, commission or non-monetary benefit coming within the scope of Article 26 must ab-initio involve a potential conflict of interest. Furthermore, we believe that prohibitions should generally only arise to the extent that a firm cannot manage the conflict. As we indicate above, we believe that an analysis of the interaction between Article 19 (1) of the Level 1 Directive and Recital 40, Articles 21 and 26 of the Level 2 Directive supports this view.

4. ***Suggestions of Price Controls:***

There are a number of references within the CP, including Paragraphs 22 and 25, that appears to indicate CESR's intention to introduce an element of regulatory price control. The first of these proposals indicates that CESR will require the value of a service to a client to meet a certain level, whereas the client, or its advisers, is the appropriate party in a position to assess the value of a particular service to them. This is followed, at Paragraph 25, by a proposal that any fee payable is required to be pitched at a level that is deemed to be proportionate to market levels. This suggests that proportionality is capable of being assessed more reasonably, efficiently and accurately by regulatory authorities than by the client and its advisers. This appears at odds with the very essence of the free open market economy espoused by the European Union.

5. ***De Minimis Exclusions:***

The absence of any proposals from the CP that trivial monetary or non-monetary benefits will be excluded from the concept of prohibited or restricted inducements is a source of concern to the IAIM. Trivial or minor benefits that do not contain any real risk of conflict or impropriety should surely be excluded. In support of this view, we would draw an analogy with Recital 32 of the Level 2 Directive, which states in relation to investment research that small gifts or minor hospitality below a level specified in the firm's conflicts of interest policy should not be considered to be inducements.

6. ***Interaction With Existing Practices, Other Regulations and Market Forces:***

We believe that the CP pays insufficient regard to existing widely accepted best practice, other applicable regulations and, in many areas, to free market forces. Examples of the best practice areas that the CP appears not to recognise are the market-led initiatives in relation to unbundling and cost disclosure and the provision by many firms of very valuable investor education to their clients. Similarly, the regulatory framework, be it derived from MiFID or other sources already contains many provisions in relation to inducements and the management of conflicts of interests, the effectiveness of which does not appear to be accepted by CESR. Finally, many beneficial market forces that have demonstrably lead to increased market efficiency, completeness and innovation may not be well served if the proposals contained in the CP are not refined substantially prior to appearing in final recommendations.

Yours sincerely,

FRANK O' DWYER
Chief Executive

ENDA Mc MAHON
Chairman, Regulation & Compliance Committee

Irish Association of
Investment Managers

Appendix

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?**

Answer 1: We believe that CESR's definition of inducements is excessively broad. A case in point is the suggestion that the provision of training services should automatically be construed as an inducement other than where it is provided at the premises of the recipient firm. Taking such a broad definition of the scope of inducements would, in our view, result in an unnecessary amount of evidential documenting of processes by firms with associated increases in costs for firms and their clients.

Recital 32 states that 'small gifts or minor hospitality below a level specified in the firm's conflicts of interest policy and mentioned in the summary description of that policy that is made available to clients should not be considered as inducements for the purpose of the provisions relating to investment research'. We believe that the principle of materiality provided for in Recital 32 should also be applied to the implementation of Article 26.

The views put forward by CESR in paragraphs 22 and 25 need also to be considered in the context of question 1 – should Article 26 apply to 'all and any fees, commissions and non-monetary benefits'? Paragraph 22 introduces the principle of proportionality, while example 1 in paragraph 25 states that 'if the commission is disproportionate to the market then it is more likely that the commission payment will impair the investment firm's duty to act in the best interests of its clients'. While CESR does not suggest that there should be a cap on the level of commission, it would appear that the firm will have to be able to demonstrate that it is adding value over and above the normal service standard in the market place in order to justify charging a higher fee/commission. This will require information to be publicly available in respect of industry standard fees/normal service standards. This raises the possibility of the requirement that commercially sensitive or proprietary information be made public, which many firms will have an issue with. This could stifle innovation. Furthermore, the implication that standard fee levels will have to be set may act as a bar to competitive market forces and could result in investors paying more for services than would have been the case in an open an free market.

We do not agree that the definition of 'proper fee' should be limited to the examples provided in Article 26(c) i.e. custody costs, settlement and exchange fees, regulatory

levies or legal fees. Limiting the definition in this way does not allow for the normal evolution in industry practice, legitimate costs associated with new products/services etc which would be more properly caught by allowing firms/local regulators to use their discretion within the proviso contained in Article 26(c) that such fees/costs 'by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.'

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?

Answer 2: We agree that an inducement that is received by a firm can create a potential conflict of interest and that therefore there is an innate link between conflicts of interest and inducements. This is recognized in Article 26(c) which provides for 'proper fees', which by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.' However, we do not agree with CESR that the treatment of inducements under Article 26 needs be broadened to take account of its interaction with Article 21. This results in a confusing and prescriptive approach. Having regard to the interaction between Article 26 and the conflicts of interest provisions elsewhere in the Level 1 and Level 2 Directives, we are of the view that there is a need to take a more principles-based approach.

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"?

Answer 3: We agree to the extent that it is likely that such circumstances will be relatively limited. However, we do not believe that these circumstances are necessarily as restrictive as outlined by the CP. In this regard, there are other circumstances that could arise (please see answer to question 4 below) which fall within Article 26(a).

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"?**

Answer 4: These could include circumstances involving the express request by a client for a payment to be made or received on their behalf. Furthermore, the CP does not address the area of non-monetary benefits e.g. how should small gifts or minor hospitality be treated? We believe that 'small gifts or minor hospitality below a level specified in the firm's conflicts of interest policy should be permitted items 'provided to or by the client'. Furthermore, a firm should be entitled to provide altruistic support to e.g. a charity event run by a client within the context of Article 26(a).

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?

Answer 5: We agree with the principle that a payment or receipt should be designed to enhance the quality of the service to the client and that it must not impair the firm's compliance with its duty to act in the best interests of the client. However, we are concerned about CESR's statement in paragraph 19 that 'there must be a benefit to the client in relation to that service, and not just to the investment firm or to other clients'. This is potentially damaging to investors and industry alike:

- How does CESR see the accommodation of product training, systems access or research, which are designed to improve the expertise/efficiency of the recipient firm and which would be of general benefit to its clients/potential clients as distinct to being of benefit to a specific client in respect of a specific service?
- In order to meet the requirement that any receipt of monetary or non monetary benefit must improve a specific service to a specific client, the industry would have to reverse many initiatives including the aggregation of orders and block trading and settlement, which would have retrograde effects in terms of market efficiency and costs to investors.
- No recognition appears to be given to the requirements, deriving from both MiFID and other regulatory sources that firms identify and manage conflicts, nor their ability to meet these requirements. As such, the proposals contained in the CP for additional costly requirements are likely to reduce efficiencies and increase investor costs for no incremental benefit in terms of investor protection.

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?

Answer 6: We would emphasise that the condition in relation to payment is that it be "designed" to improve service and would caution against any eventual position that requires "ex-post" evidence that the service has improved. It also strikes us that the Directive does not require that the payment be **solely and exclusively** designed to improve the service. We also have some concern in relation to the interaction of the proposals with other provisions, most notably Recital 39, which provides that where investment advice or recommendations are not "biased", that the payment "should be considered as designed to enhance the quality of the service".

As already commented in response to question 1, in order to comply with the principle that commissions are 'not disproportionate to the market' it would appear that the firm will have to be able to demonstrate that it is adding value over and above the normal service standard in the market place in order to justify charging a higher commission. This will require information to be publicly available in respect of industry standard fees/normal service standards. As indicated above, this could ultimately stifle innovation and competitiveness. Is also difficult to see how applicable Level 1 and Level 2

provisions justify the proposal to regulate prices. One final point that we would like to make in relation to the value of the service is that the client and/or its nominated advisor will clearly be the best placed to make a subjective assessment of the value of a particular service to them.

Notwithstanding our view expressed in response to question 1 that training should not be considered as an inducement, we agree with the higher level principle contained in example 4, that training provided by e.g. a product producer should be relevant and that the content rather than the location should be the primary benefit provided. However, we disagree with CESR that all such training should be provided on the premises of the investment firm and that the content should be linked closely linked with the service provided. It will often be the case that an investment firm will not have the facilities on site to cater for this type of training or that an off-site geographically centered location will be necessary to cater for regional sales forces. It may also be the case that the product provider may wish to address the general training requirements of its distributors by introducing them to new instruments/ financial sector developments rather than specific product/service training. As we have indicated elsewhere in this submission, it occurs that a principles-based approach will be much more effective, practical and "future-proofed" than a prescriptive approach.

CESR's examples do not specifically address the provision of non-monetary benefits to clients, which could include e.g. invitations to clients to attend seminars aimed at improving their knowledge of investment markets/ new investment instruments.

We do not entirely agree with the view taken by CESR in respect of example 7 that the provision by a third party to a firm of general office equipment such as computer equipment would necessarily impair the investment manager's compliance with its duty to act in the best interests of its client. While there are some such arrangements, involving benefits of a very high commercial value that may cause conflict, there are a large number which would not and which would involve service enhancement. In such cases, both the recipient firm and the third party (if a regulated entity) will have a general duty under MiFID and other applicable regulations to manage any conflict. Furthermore, it is likely that such arrangements could enhance the quality of the investment service provided by the investment firm to its client, including e.g. meeting best execution arrangements.

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?

Answer 7: Yes. We agree that it is unlikely that a detailed guidance could provide for all circumstances and situations and it is likely to become out of date and incomplete very quickly. We also agree that the summary disclosure required under 26 (b)(i) must provide sufficient and adequate information to enable the investor to make an informed decision and that a generic disclosure, which refers merely to the possibility that the firm might receive inducements will not be considered enough. However, a firm should be permitted to provide a client with a generic disclosure as long as the information provided is sufficient and adequate.

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**?

Answer 8: Yes. We agree with CESR's view that the arrangements that need to be considered and, where relevant, disclosed are those that can influence or induce the firm which has the direct relationship with the client.

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?

Answer 9: We agree with CESR's view that the full amount of the commission should be disclosed rather than just the portion paid to the tied agent.

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

Answer 10 : We have no additional observations in this regard.

Softing and Bundling Arrangements

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

Answer 11: While there is a potential for conflict of interest as already commented on by CESR in example 7 paragraph 25, we would expect that the best execution requirements under MiFID will provide a very useful control in this regard.

We would also reiterate our observations above in relation to the assumption, envisaged by Recital 39, that the service will be enhanced in the absence of biased advice or recommendations. Requirements that benefits achieved through softing and bundling arrangements must be specific to particular clients and particular services will militate against market efficiency and cost reduction.

We would have a specific concern in relation to the statement that bundled services do not offer any transparency. In this regard, initiatives such as programme trades and execution-only trading facilitate full transparency in relation to the respective values of the constituent elements of a bundled service, as has the preparatory work completed in relation to CSAs and cost disclosure codes.

We believe, however that it would be appropriate for CESR to recognise the regulatory developments that have occurred in recent years in respect of softing and unbundling, most notably emanating from FSA and SEC. In this regard, there has been a very effective, industry-led, initiative in this area, resulting in widely accepted good practice including Commission Sharing Agreements.

We are therefore of the view that Softing and Unbundling is an area that, subject to answer 12 below, may be preferable for CESR to consider in the context of a separate consultation.

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

Answer 12: While a common approach may be useful it is by no means a prerequisite. We believe that any such initiative should be industry-led and any consultation should be informed by recent regulatory and practical developments in this area and should facilitate the introduction of guidance.

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

Answer 13: See answer to question 12 above.