

9 February 2007

By e mail

The Committee of Securities Regulators
11-13 Avenue de Friedland
75008
Paris
FRANCE

CESR Consultation: Inducements under MIFID

Dear Sirs

We are grateful for the opportunity to make comments on this paper. We have three general comments which relate to CESR's interpretation of Article 26 (b) (third party receipts and payments). These are:

- ◆ The concept of proportionality
- ◆ Substitute products and related level playing field issues, and
- ◆ Disclosure of 3rd party vs. in-house fund distribution costs

The concept of proportionality

Some of the examples in the CESR consultation paper refer to the proportionality of payments received by fund distributors. We consider this newly added concept to exceed the requirements of article 26 b) ii) of the Implementing Directive, as it does not add much to the question as to whether inducements are legitimate or not. "Proportionality", which we consider to be a highly subjective concept, would imply the measurement against market benchmarks which are not defined by CESR and which we would not expect to be defined, as this would constitute an unacceptable intervention in market-driven practice.

We understand the requirement that inducements must be "designed" to enhance the quality of services to be an obligation of means rather than an obligation of result. We read the CESR interpretation to put the obligation on the fund promoter and the party receiving inducements to justify that the payments are proportionate; this could entail potential civil liabilities of these parties vis-à-vis end investors, in the case of differing subjective judgement of proportionality

Substitute products and related level playing field issues

We note that the '3L3' work programme for 2007¹ has, as a priority issue, finalisation and follow up work on the subject of 'substitute products and related level playing field issues'. This consultation raises a level playing field issue with regard UCITS and other products sold to retail investors. The fact that MIFID's scope does not cover all retail products is a weakness, but it is imperative that the level 3 regulators impose a similar regime for all retail products with regard to disclosure of inducements.

Applying stringent disclosure requirements to one type of financial product but not others will naturally result in distributors reconsidering whether they wish to sell that product. So, there is a danger that rigorous and costly requirements to disclose the way a distributor is remunerated by a UCITS provider may result in distributors selling non-scope products to avoid disclosure altogether. This will lead to a perverse result, whereby products that already have a high degree of transparency in relation to expenses

¹ CESR 06-707 3L3 Work Programme 2007, page 3, B.3

are less likely to be sold to investors than other products where the true cost is hidden within the product's structure.

Disclosure of 3rd party vs. in house fund distribution costs

CESR will be aware that in the past, distributors of funds typically sold to their customers only those funds managed by their internal fund management companies. As open architecture (i.e. the use of third party funds) has become more widespread in the EU, this has revealed how much of the fee paid by the customer is paid to the fund manager and how much to the distributor. In some cases, well over two thirds of the charge paid by the customer goes to the distributor and one third to the fund manager – something the Commission's White Paper on investment funds has confirmed².

However, it is unclear from the consultation whether the distributor selling-in house fund products will be subject to the same level of disclosure as those distributing third party products. A distributor that uses a third party fund has to negotiate an arm's length price with the fund manager. Where the distributor uses its own fund, there is less transparency on the fund management/distribution cost, but the overall cost paid by the customer will typically be the same.

We would not disagree with the concept that a greater level of transparency over the costs charged by the distributor can help bring downward pressure on distribution costs (and so annual management fees). This is at the heart of the Commission's thinking when looking to reduce the overall cost of UCITS products. But the disclosure regime must be equally as robust for the sale of third party funds as for in-house funds (and for other types of products as stated above). If not, market forces may act by reversing the trend towards open architecture – as distributors will be more likely to sell in house products if disclosure of the true cost of distribution can be avoided. Put another way, the move to open architecture which, according to the Commission's White Paper 'can be to the great advantage of the investor' will be stymied, if not ultimately reversed, unless the disclosure regime is consistent between third party and in-house products.

Yours sincerely

Simon Vernon

² White Paper on enhancing the single market framework for investment funds COM(2006) Section 2.2.