CNMV ADVISORY COMMITTEE ANSWER TO CESR CONSULTATION ON INDUCEMENTS

CNMV Advisory Committee is the Spanish Securities Market Commission Board's advisory body. The Committee is chaired by the Vice-President of the Commission, and, amongst their Commissioners, are designated representatives of the members of all the official secondary markets, the issuers and investors, as well as a representative of each of the Autonomous Regional Governments with powers in securities market matters and in whose territory there is an official secondary market.

The Committee thanks CESR for the opportunity to participate in this consultation process and hopes the following comments to be useful and taken into consideration in the final CESR´s recommendation to its members.

COMMENTS

- In CNMV Advisory Committee´s opinion, the Level I Directive, in order to ensure investor protection, provides for the treatment of conflicts of interest (Article 18), as well as the firm´s duty to act honestly, fairly and professionally in accordance with the best interests of its clients (Article 19.1). Both principles are developed by Articles 21 and 26 of the Level II Directive, which introduce the concept of inducement. *Since the concept of inducement is not established by the Level I Directive, but it is developed by the Level II Directive, as an implementing measure of the Level I, both Lamfalussy process to EU securities markets and Article 64 of the Level I Directive, require that* such implementing measures "*do not modify the esential provisions of that Directive*"; therefore, *interpretation and application of the inducements regime should be confined to the scope of conflicts of interest and duty to act honestly, fairly and professionally in accordance with the best interests of its clients*.

- *Obligation of acting honestly, fairly and professionally in accordance with the best interests of its clients, established by Article 19 of the Level I Directive, has not to be incompatible with the perception by investments firms of a proper remuneration*; *moreover, a proper remuneration can be considered as a guarantee of an honest, fair and professional actuation, in accordance with the best interests of the clients.*

  Nonetheless, the approach proposed in the consultation paper seems to establish a presumption, whereby any payment in relation with an investment service received by an investment firm from a third (different from the client), is prejudicial to the investor´s interests. According to Paragraph 9 of the document, *"In principle a payment to a third party or a receipt from a third party in relation to a service provided to a client could put the investment firm in breach of its duty to act in the best interests of the client. So, such a receipt or payment creates a potential conflict of interest between the investment firm and its client".* Nevertheless, in nearly all the cases, this approach is not correct. For example, when a client comes into a bank office to buy some units of a particular collective investment scheme, that he or she has previously decided (according to the information available in the Internet, press or in any other sources), the bank is not providing a service of portfolio management or investment advice, since the client has taken the decision by his own. In this example, the bank is acting like a sales agent, and provides a distribution service to the management company, by which they have arranged some commissions. These commissions do not give rise to a conflict of interest, nor impair the firm´s duty to act properly, since the decision of the client is not influenced by the bank.

- So, *inducements regulation should be confined to the context of both conflicts of interest and impairment of the obligation of acting properly, honestly, fairly and professionally in accordance with the best interests of its clients.*

The alternative approach we propose operates as follows:

- the investment firm should identify what kinds of inducements give rise to conflicts of interest or impair the invesment firm´s duty to act in accordance with article 19.1 of the Level I Directive;
- only for those cases, the investment firm should establish organisational and administrative arrangements to avoid detrimental effects on its clients;
- if such arrangements can not ensure the protection of the client interests, the inducement shall be prohibited, unless three requirements established by Article 26(b)are fulfilled, namely:
    a) prior disclosure,
    b) inducement designed to enhance the quality of the service and,
    c) impairment test of compliance with the firm´s duty to act in the best interests of its clients.

A flowchart to illustrate this alternative approach is provided within Annex to this paper.

- *Requiring previous disclosure of any commission perceived by the investment firm in return for distribution of collective investment schemes*, regardless the arising of a conflict of interest, *might involve a lot of drawbacks*, in particular:

    a) ***Distortion of the agreements between management companies and distributors and risk of higher distribution costs***. Distributor´s remunerations are individually negociated, so confidentiality is of strategic importance, since it allows management companies to obtain lower distribution costs, savings that can be passed on to investors through lower management fees.
    b) ***No additional benefit for investors***. Collective investment schemes, in particular those harmonized at EU level, have their own regime of information, which requires a prior disclosure of any commmissions and/or expenses to be charged to the unitholder; so, the disclosure of how these commissions are allocated between the members of the distribution channel is not relevant for investors, since this allocation has no impact on their investment profitability.
    c) ***Discouragement to open architecture,*** in favour of the distribution of in-house products.
    d) ***Detriment to collective investment schemes competitive position,*** since it could discourage investment firms from distributing CIS in favour of other substitute financial products, that may be not subject to the same disclosure requirements on distribution costs.

    In addition, it is worth mentioning that the disclosure of the firms benefits to their clients, even in the absence of either a conflict of interest or the impairment of the duty of acting properly, is a practice not required to any financial or non financial service, and, to a certain extent, contrary to the free-market economy.

- Without prejudice to our previous arguments, *the document does not shed any light about the requirements applicable to prior disclosure of those fees, commissions or non monetary benefits that qualify as incentives*, nor clarifies whether the information should be publicly available or should only be provided to the client involved in the transaction either. *In addition, CESR introduces some abstract concepts, such as "disproportionate to the market" or "disproportionate benefit to the firm relative to the value of the service provided to the client",* to assess when a particular commission does not impair compliance with the firm´s duty to act in the best interests of the client; such concepts, *that are not mentioned in the Directive and exceed its scope,* should be avoided.

    On the other hand, the requirement of a proportionality to the market *could bring some proper under the free-market economy rules and widespread practices to an end*, for

example, those whereby the percentage of commission to receive by the distributor, instead of being fixed, increases with the volume distributed.

In addition, the concept "*disproportionate to the market*" gives rise to an uncertainty, namely *which market is in charge of setting up the standard*. The selection of a concrete market to act as a yardstick for the rest is only acceptable if all the markets under comparison have the same fee structure. Nevertheless, the fact is that, *at least, two different models for the distributor´s remuneration can be distinguished*. In the first model, it is established a subscription and/or redemption fee, usually as a percentage of the investment, which is received by the distributor as a remuneration for the provision of the distribution service. In the second model, the distributor receives a percentage of the management fee from the management company. In same cases, the percentage of the management fee is fixed, while in other cases it can vary according to the volume distributed. A "mixed model" is also possible, whereby the distributor receives a subscription fee, as well as a percentage of the management fee. A number of european countries (Spain amongst them) fit the second model, whereas others opt for the first one. Taking into account *that one of the aims of the Directive is to enhance a single market, it should be the european market, and not the national ones, the standard to determine whether a commission is proportioned or disproportioned to the market. However, the existence of different fee structure models make it impossible to establish a standard, valid for the european single market as a whole.*

Finally, the spread of additional controls on fees and commissions, as established by CESR approach, could disturb the cross-border marketing of those financial instruments whose providers do not have a distribution network in other countries.

- *CESR development of an european common approach to softing and bundling arrangements would be a valuable contribution,* as long as this approach takes into account the benefits of these arrangements (and not only their drawbacks), and does not imply a break with the current international financial markets practices.

As a final comment, ***the examples contained in the CESR document appear to concentrate excessively on collective investment schemes, whereas that is a sector that is regulated by a recent Directive which contains very strict rules regarding disclosure and investor protection, whose distribution structures are absolutely transparent to regulators, and these aspects have not given rise to any complaints in practice.***

Perhaps this should not be the case since the regulation on incentives also applies, for example, to public offerings, while CESR's approach in this consultation might affect the distribution of securities among the public with a view to listing in regulated markets, thus indirectly increasing the cost of processes of this type.

***ANNEX:* ALTERNATIVE APPROACH TO FEES, COMMISSIONS AND NON MONETARY BENEFITS RECEIVED BY INVESTMENT FIRMS IN CONNECTION WITH THE PROVISION OF AN INVESTMENT OR ANCILLARY SERVICE.**