ASSORETI

Associazione Nazionale delle Società
di Collocamento di Prodotti Finanziari
e di Servizi di Investimento

Secretary General

Roma, 22nd December 2009
Prot. n. 199/09

CESR - the Committee of
European Securities Regulators
11-13 avenue de Friedland
75008 Paris
FRANCE

Via CESR's website

Subject: Inducements: good and poor practice (ref. CESR/09-958).

First of all, Assoreti wishes to express its utter appreciation for the remarkable work done and the method used, based on prior analysis of market practices and aimed to establish common guidelines across the EU.

Assoreti – given the nature of associated companies (mainly, banks and investment firms) engaged in the provision, outside their premises, of financial instruments and investment services through tied agents – would like to focus its contribution on examples of *poor practices* 3 and 4 (p. 25) included in Question VIII[1] and IX[2]; particular regard will be devoted to the case where the investment firm distributes financial instruments and provides investment advice to its clients and it is remunerated (where appropriate also for the latter service) through rebates from product providers.

Poor practice. Example 3 (p. 25 of the consultation paper): «An investment firm distributes financial instruments and provides investment advice to clients. These services are remunerated indirectly through rebates from product providers. It manages conflicts of interest that may arise due to the third-party payments received mainly by applying strong suitability tests».

In general terms, Assoreti believes that the receipt of various level of rebated commission from product providers could give rise to conflicts of interest that the investment firm has to manage with accurate organisational and administrative arrangements/procedures (in addition to *ex-post* control); these arrangements/procedures should be appropriate to reasonably ensure that

[1] Question VIII: «Do you have any comments regarding CESR's view that arrangements 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?»

[2] 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?»

recommendations given to clients arise only from a process of comparative assessment of products' characteristics with the profile of that clients (*i.e.* suitability test).

In this respect, CESR's view seems to be that a poor practice occurs in any case when the investment firm manages conflicts of interest, that may arise due to the third-party payments, only by applying suitability tests, even if the suitability test is strongly applied (poor practice 3).

Assoreti believes that this conclusion is too strict. Actually, the investment firm should discretionally evaluate the arrangements/procedures to be taken in order to implement the duty to act in the best interest of the client.

Truly, at a first glance, CESR seems to confirm this last – more elastic – interpretation as it states that «*an investment firm has for ensuring compliance with the rule requiring suitability assessments in relation to investment advice under Article 19(4) of MiFID. But to avoid bias firms will also need to think whether there are additional steps they need to take to ensure that they are acting in the best interests of their clients and effectively managing the conflicts of interest*» (see comment at page 26 of the consultation paper). According to this statement, an investment firm should take the measures deemed necessary on a case by case basis and might even get to think, legitimately, that no further steps are due in the light of all the circumstances of the case.

However, CESR's comment continues stating that «*without such additional steps, the sole reliance on the suitability test to manage conflicts of interest, as in example 3, is likely to be a poor practice*». Indeed, between this statement and the preceding one seems to be a logical gap, as it moves from an obligation to evaluate additional arrangements to an obligation to adopt them at all times, otherwise a poor practice occurs.

Furthermore, the severity of this interpretation would suppress the practices legitimately developed to date by investment firms and induce them, on the one hand, to abolish the rebate of commission and, on the other hand, to introduce commissions /fees paid directly by the client (as it is also expressly stated at the end of the comment to poor practice 3, at p. 26). This conclusion, however, would have the factual consequence to delete paragraph 39 of the level 2 Directive, according to which «*the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client*». This paragraph seals the legitimacy of these rebates of commission, since these are the remuneration of the advice service provided to client and that, as such, must not be deleted. Therefore, a severe criticism of this method of payment would affect the value chain, obliging firms to convert the existing process (based precisely on rebates of fees); this would be contrary to the principle according to which the regulation has to be neutral as to the choice of business activity that the firm may adopt.

Therefore, Assoreti hopes that this Authority will reconsider the case laid down in the example 3 of *poor practices* and provide, if ever, that:

- a *poor practice* occurs when the investment firm believes that the suitability assessment satisfies *per se* the duty to act in best interests of the client, without even thinking if rebates of commissions may impair the proper implementation of this duty;

- a *good practice* occurs when the investment firm properly relies on the suitability test and assesses the need to take – and takes when necessary – additional steps to ensure that it is acting in the best interest of the client and effectively manages the conflict of interest arising from receipt of various level of rebated commission from product providers (for example, by defining in advance its commercial policy and/or articulating the suitability test with predetermined parameters as to ensure that recommendations given to clients arise only from a process of comparative assessment of products' characteristics with the profile of that clients).

Poor practice Example 4 (p. 25 of the consultation paper): «An investment firm providing the investment service of investment advice as well as distributing financial instruments receives various levels of rebated commission from individual product providers. The investment firm's advisers and sales staff are rewarded, at least in part, in relation to the levels of commission generated by the recommendation/sales they individually make to clients.»

Even before analysing the merits of this example, Assoreti believes that it refers in fact to a situation – the payment of remuneration to persons, including tied agents, that provide investment advice and distribute financial instrument to client on behalf of the investment firm – that is outside the scope of Article 26 of the Level 2 Directive.

As stated by CESR, only rebates from product providers to an investment firm providing investment advice and/or distribution services fall within Article 26 of the Level 2 Directive; on the contrary, the compensation of its staff, and particularly of tied agents, by an investment firm is outside the scope of Article 26 of the Level 2 Directive. Indeed, the compensation of the staff is an internal payment and falls under Article 23 MiFID according to which the investment firm is fully and unconditionally responsible for its tied agents (see par. 50 of the consultation paper and even before the Feedback Statement, CESR/07-316, par. 26).

If this is true, the facts provided in example 4 should be evaluated on the basis of conflicts of interest rules and not on the basis of inducements rules. Viceversa, CESR seems to qualify the compensation to the staff as inducements, stating that «*where, as in example 4, individuals providing advice and/or distributing financial*

instruments can obtain a higher reward for recommending or selling particular types of products or the products of a particular provider, this creates a clear danger that their advice and/or sales pitch will not serve the best interests of the client» (see p. 26 of the consultation paper): by stating this, of course, CESR is evaluating the fact in the light of Article 26 (b) of the Level 2 Directive (*i.e.* inducements).

As mentioned, Assoreti believes that the rebates of commissions to the staff (employees and tied agents) should be considered only within the scope of MiFID rules on conflicts of interest, according to which investment firms are required to identify and manage conflicts of interest arising from the receipt of various level of rebated commission and, when the arrangement made are not sufficient to ensure that risks of damage to client interests will be prevented, to clearly disclose the nature and/or sources of conflicts of interest to the client (*i.e.* the Directive imposes a transparency rule on inducements and does not ban inducements *per se*).

That being stated, example 4 does not identify a poor practice on inducements and, therefore, it could be removed from this document that relates to inducements.

In any case, if CESR decided to maintain a reference to rebates to staff and tied agents, it would consider whether to rewrite the mentioned examples, as to remove the bias against the current (and legitimate) market practices and to introduce examples of good practice that explain the efforts of the industry to serve the best interest of the client, without affecting the independence of the investment firm in choosing how to serve this interest.

In particular, the wording of the example 4 seems to suffer this bias where it simply stays that a poor practice occurs when «*the investment firm's advisers and sales staff are rewarded, at least in part, in relation to the levels of commission generated by the recommendations/sales they individually make to clients*». Indeed, it would be better to highlight that a good practice occurs when the investment firm fixes flat level of rebated commission to its staff.

Similarly, Assoreti believes that a *good practice* occurs when the investment firm structures rewards in a way which avoids creating an incentive to recommend products which involve the least time and effort for advisers (rather than an exception within the comment of a poor practice, as is currently provided by p. 26 of the consultation paper). Moreover, it has to be beared in mind that the recommendation to clients involved several factors, of which the cost is only one, such as the complexity of product management, the quality of the issuer or provider, past performances and expected returns of the product, instructions given by the client at the last moment, as, for example, the reference to a specific benchmark …

Vice versa, the severity of the wording of example 4 shall bring the investment firms to advice/distribute always the product cheapest for the customer; however, the cheapest product is not always suited to the client's financial needs; thereby the professionalism of tied agent is debased. Indeed, the fact that tied agents are close to

the client represents added value in order to identify the financial instruments that are suitable for him, specifically with a view to serve his best interest.

In conclusion, having regard to example 4 of *poor practice*, Assoreti asks to this Authority to evaluate, firstly, its relevance within a document relating to inducements and, subordinately, if it is still deemed relevant to the subject of this document, to consider these examples of good practice (in its place):

- a *good practice* occurs when the investment firm's tied agents, that make recommendations / distribute financial instruments to clients, are rewarded with a flat commission, regardless of the level of commission generated by recommendations/sales made to clients; in this way the investment firm inhibits *ab origine* conflicts of interest arising from rebates to tied agents;

- a *good practice* occurs when the investment firm adopts appropriate monitoring and controls to deal with conflict of interest arising from various level of rebated commission to tied agents that make recommendations / distribute financial instruments to clients. These arrangements are designed to ensure that tied agents make recommendation to clients with due professional care, taking into account not only the price of the product, but also a set of parameters such as complexity of product management, quality of issuer or producer, past performances and expected returns of the product, instructions given by the client at the last moment, as, for example, the reference to a specific benchmark …

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Thank you in advance for your kind attention on the above-mentioned considerations.

Yours sincerely.

Marco Tofanelli