

CESR

11-13 avenue de Friedland
75008 PARIS
FRANCE

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Dear Sirs,

RESPONSE TO CESR'S CONSULTATION PAPER ON INDUCEMENTS UNDER MIFID

Thank you for your invitation to respond to your public consultation paper on the treatment of Inducements under the Markets in Financial Instruments Directive (CESR/06-687). Presented in the appendix I to this letter, you will find our answers to the specific questions posed in the paper.

1.- General comments.

Our view on the consultation paper is that it exceeds the basic legal principles foreseen under MiFID Level 1 Directive and the implementing Level 2 Directive. In providing proposals that may help CESR's members to set out a common approach to the operation of article 26 of the Level 2 Directive, the consultation paper creates significant uncertainties. The consultation paper (i) introduces undefined legal concepts out of the scope of MiFID such as "proportionate/disproportionate benefits" to the firms relative to the value of services, market, benefits to clients, (ii) takes that investment firms operate unfairly and dishonestly as starting point of its analysis, and (iii) seems to expand the community legislator's view to scenarios which are not initially contemplated under the Level 2 Directive provisions on inducements.

We are of the opinion that well-established market practices throughout the Community on payments to third parties and receipts from third parties within the investment services framework have properly worked alongside with ethic and professional commercial behaviours of market participants. Under this view, it is clear that such well-established market practices have not created disadvantages or even damages to clients. In most cases they are just arms-length fair commercial agreements that benefit the final customers by enlarging the list of financial products that are made available to them. This seems to be also the approach that both inducements regulation and supervision have had in certain jurisdictions (i.e. U.K.) where this topic has been under scrutiny, very far from the "exceptional and suspicious" view that can be perceived under the CESR document.

Your consultation paper focuses on the collective investments schemes (in particular UCITS as defined under the Council Directive 85/611/EEC) as a case study for the practical application of MiFID inducement regime. However, CESR approach in its paper seems not to take into account that UCITS products and their Management Companies are already subject to the harmonized conditions imposed in the current community legislation. Such legislation provides with a wide and strong regulatory framework for UCITS and their Management Companies to operate in compliance with

strict conduct rules and investors protection requirements, transparency conditions, information obligations to investors, amongst other issues.

Under this framework, the interpretation of CESR paper on the distribution structures or on the commission arrangements executed in accordance with well-established market forces of the asset management market could potentially discourage investment firms from marketing collective investment schemes rather than giving examples to illustrate guidelines for a common approach on a specific matter. In other words, should CESR paper approach be not re-defined taking into consideration the whole and experienced regulatory market on UCITS, may produce significant damages in the competition

2.- Our understanding of the inducements regulation in MiFID Directives.

Both the recitals and the articles of Level 1 Directive rely on the fact that investment firms and their groups perform various investment services, auxiliaries services or other activities that may, potentially, create conflicts of interest. The Directive, however, does not prohibit various activities neither requires the total absence of said conflict of interests, but imposes to the investment firms the obligation of assuring that said conflicts are not in detrimental to their clients' interests (see witness 39 Level 1 Directive).

The regulation of inducements in MiFID Directives may be seen as part of the general regulation of conflicts of interest. Accordingly, it can be argued that, as far as the analysis of any given inducement from this general perspective brings to the conclusion that there is not a conflict, an additional analysis under the specific inducements regulation (mainly, article 26 of Level 2 Directive) is not required.

A different approach, which seems to be the one followed by CESR document, considers that inducements, whatever its relationship with conflicts of interests may be, are only (or, at least, primarily) subject their own regulation under article 26 of Level 2 Directive. This means that the investment firms have to check each of their agreements which include inducements against the rules contemplated in that article and assign them into one of the categories therein established. It has to be acknowledging that this approach sticks better to the text of the MiFID Directives. It is important, however, that the interpretation of article 26 of Level 2 Directive does also adhere to its text, thus avoiding positions that do not find support in it and would lead to a wrong, unacceptable an extensive interpretation of its content.

Accordingly, article 26 of Level 2 Directive has to be read in its own terms, meaning the following:

(1) Provided that a commission payment or receipt is convenient or necessary fee for the provision of the investment service to the client, and due to its nature, can not give rise to conflict with the firms' duty to act in the best interest of the client (taken into consideration that the investment firm has previously managed in a reasonable and sufficient extent the potential conflict of interest), it falls under the "proper fees" concept (i.e. Art. 26 (c)). There is no reason why this category should be considered "residual" in such a way that it can be used only in limited exceptional cases. Nothing in article 26 (c) backs said restrictive approach. The only two aspects to be considered are, as just mentioned, (i) convenience or necessity for the provision of the service; and (ii)

exclusion of the possibility that the inducement, by its nature, conflicts with the best interest of client standard.

In addition to some others that are included in the annex of this document as comments to the examples provided by CESR, it is worth to identify some cases in which this concept applies.

As a general idea, if the inducement is being paid or received in the framework of a commercial agreement among the investment firm and a third party allowing the investment firm to deliver financial products or services to its customers, seems without doubt that the “necessity or convenience” test is met.

As about the “conflict in nature with best interest of client standard”, every time that the characteristics of the inducement are such that exclude said conflict the test will be met. For instance, if the fees agreed with the third party are not linked to the volume of products sold to clients. Or if the general structure of fees of the investment firm is such that the commissions charged to its customers are the same for general categories of investment products, irrespective of the commercial fees agreed with the different providers of them. Or if, whatever the agreements are with the providers of the products, the sales force of the investment firm is not influenced whatsoever by the fees therein established or even are not aware of them. Or because some other protection elements, as the ones that will be identify in the next paragraphs, are in place.

The service that article 19.6 of Level 1 Directive defines as “execution only” will definitely, in our view, make impossible that said conflict is generated. The investment firm is only acting as mere receiver and transmitter of orders, and its service may not be influenced by the fact of receiving a commission from a third party; the client decides the investment to be made and orders the investment firm to execute it. The client is only expecting the investment firm to follow the instructions and the investment firm should be able to perform them under the best execution requirements.

As far as **investment advice and portfolio management**, similar arguments can be used that may lead to the conclusion that the second test under 26 (c) is also met.. Firstly, the investment firm providing those two services has a reinforced conduct of business obligations due to the suitability test imposed by article 19.4 (Level 1 Directive) which requires that only products that best fit to the client needing and characteristics are recommended.. Secondly and as already mentioned, the investment firm has to maintain organisational and administrative arrangements to prevent conflict of interest to adversely affect the interest of its clients (adequate barriers to prevent that the perception of such commission affects the management or the advice services provided to the client). In case the two mentioned protections are fully observed by the different investment firm departments (the one executing the agreements and the one acting before the client) the existence of the commission arrangement should not in any way influence or induce the investment firm professional advising or managing the client's portfolio to act or decide differently as how it should act in a proper, professional and fair manner. It is worth noting that this type of commission agreements are standardised in the markets

(2) In other cases (i.e. Art. 26 (b)) where the agreements reached with third parties may be qualified as inducement which may potentially affect the client's interest, the features required under article 26.b for its acceptability (to be clearly disclosed to the client in

advance, to be designed to enhance the quality of the service to the client, and not to impair compliance with the firm's duty to act in the best interest of the client) should be observed.

Regarding the disclosure obligation of article 26 (b) we think that the CESR document should clarify that it will be covered if, for instance, the information is provided on an aggregate basis, through an accessible communication mean (i.e. web) and with an indication of the range of inducements applicable to each category of investment services

Should you would like to discuss our views in further detail, please do not hesitate to contact us.

APPENDIX ENCLOSED

Appendix – answers to questions within the CESR consultation paper Ref: CESR/06-687

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?

Yes, since it is clear that Article 26 of Level 2 Directive which provides with definition of “inducement” refers 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. However, it is essential to understand the legal context where such definition under Art. 26 operate: the heading of such article 26 may be deemed misleading since Art. 26 covers both (i) fees, commissions and non-monetary benefits falling under the sense of what “proper fees” (i.e Art. 26 (c)) means and (ii) others that may be qualified pure inducements which purpose is to influence/induce the investment firm to act differently from how they would otherwise have done and contrary to the best interest to the client.

Article 26 should, therefore, be construed alongside with the Directive approach on conflicts of interest.

In addition please note that any approach in connection with the regulation of inducements should be confined within the investment firm’s relations with 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?

No. We fully disagree with CESR views on the interaction of Art. 26 of MiFID Level 2 Directive with Article 21. Please see above our general comments.

Additionally, we do not agree with CESR restrictive view on the items that may be considered under Article 26(c), as follows:

- The wording of such art refers to fees which enable or are necessary for the provision of investment services (the items included in such article 26(c) are purely non-exhaustive examples) and which by their nature cannot give rise to conflicts with the firms duty to act honestly, fairly and professionally in accordance with the best interest of its clients.
- It is required to make a distinction between what pure “inducement” is and the requirement to pay for a service deemed as the unique way to give access to e.g. a certain product/service, a certain execution venue. Likely, pure “inducements” cannot be confused with the “added value” factor (which may be under the form of non-monetary benefits) that a service provider may offer to its clients within its commercial relations, provided that such remuneration (either it is a payment or a receipt) does not create a conflict of interest. Thus, any payment done under the framework of a commercial relationship with a third party which does not influence the investment firm to act differently (because no conflict of interest arise) should be deemed included under this article.

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"?

CESR view introduces an unreasonable restrictive view of the circumstances in which an item is applicable. The wording of Article 26(a) does not provide with such restrictive approach.

We do not agree with the fact that such item is confined to the investment firm acting as a mere conduit for the payment or receipt acting on the instructions of the client. We are of the opinion that a non-restrictive view of this question should apply whenever the fee, commission or non-monetary benefit is paid or provided to or by the client or a person on behalf of the client. Therefore, CESR interpretation does not provide with reasonable approach to this question rather than creates higher uncertainty.

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"?

As a non-exhaustive example, suppose the case where there is a high-size investment portfolio client who reaches an arrangement with a certain broker (B) who provides with execution venue facilities and, on the basis of such arrangement, the client imposes on any investment firm (A) providing to him investment services in connection with his portfolio the condition to execute all his brokerage portfolio transactions via such broker (B).

In such example, the client has agreed with B the fee he will be charged for execution of orders transmitted via the investment firm A. The client could have agreed that B will pay A, a commission for the services rendered by A as an investment firm. Here is also clear that B acts on behalf of its client and the arrangement falls under Article 26(a) and is not a third party for the purposes of Article 26(c) to be met.

Question 5: Do you have any comments on the CESR analysis of the conditions on third party receipts and payments?

We do not agree with the particular conclusions reached by CESR in its analysis as follows: CESR analysis in Paragraph 22 and in some examples introduces certain undefined legal concepts which are clearly out of the scope of MiFID such are "proportionate/disproportionate benefits" to the firms relative to the value of services, the market standards, and/or the benefits to clients. Open market conditions should set the fee levels of services rendered and those fees should not be assessed through other considerations.

As explained above, we are of the opinion that well-established market practices throughout the Community on payments to third parties and receipts from third parties within the investment services framework have properly worked alongside with ethic and professional commercial behaviours of market participants. Under this view, it is clear that such well-established market practices have not created disadvantages or even damages to clients. Current transparent market practices in connection with the

prices formation, open-market conditions for all participants when providing investment services, and the fact that the financial system operates on a multiple-factors basis are - amongst others- elements which can not be forgotten when this particular matter is analyzed.

Examples review:

We assume that examples proposed by CESR within its analysis are provided with the aim of creating an open discussion for the investment firms to define their policies and to adopt internal decisions accordingly. It is also our understanding that it has not been CESR intention to adopt a list of prohibited practices. We also share the opinion that this Examples review should have been taken into consideration other type of financial products rather than collective investment schemes.

Example 1.- As a general principle, it is not acceptable any assumption which provides that the receipt of such commission necessarily means that the investment firm is influenced in any way when providing investment advice or managing discretionary portfolios. Such commission-arrangement would never impair the firm's duty to act in the best interests of the client; furthermore, in providing advice or portfolio management the investment firm is automatically subject to reinforced conduct of business obligations due to the suitability test imposed by Article 19.4 of Level 1 Directive which obliges the investment firm, once obtaining the necessary information, to recommend to the client those financial instruments which are suitable for him only (and not others), thus, the best-product-advice is already ensured by these rules (in addition to the application and observance by the investment firm of all MiFID compliant measures to prevent and manage conflict of interests are met and in place). Otherwise, it should be prohibited.

In any case, the receipt of such commission should be analyzed under Article 26(c) basis (i.e. the "proper fee" approach, i.e. Art. 26 (c)). In our opinion, Example 1 falls under Article 26(c) approach, given that such commission arrangement is a standard practice, is deemed necessary in order to give the client with access to certain products and by nature it does not conflict with the firms obligation to act in an honest, professional and fair way in accordance with the best interest of its clients

Example 2.- Our comments to Example 1 applies. Additionally, given that no investment advice or portfolio management exist no analysis of whether such commission may affect the investment firm behaviour is required. Therefore, Article 26 (c) approach fully applies.

Example 3.- CESR approach in this example is not acceptable given that starts from the assumption that there is no benefit for the client under this arrangement. The review of the circumstances raised under this example should be analyzed under the light of the best execution policy.

Any and all centres of execution selected by the investment firm should be those which systematically ensure the best execution for the orders. Should it create a conflict with the rules on inducements (and therefore, it may be deemed as not permitted), the

general principles on best execution under MiFID could be affected. Therefore, our view is that Article 26 (c) approach fully applies.

Example 4.- We should agree with CESR initial approach to consider such example on a case-by-case basis. Then, the analysis of the particular circumstances is essential.

Again CESR paper deals with examples which improper interpretation could distort well-established practices by market forces which have never affected investment firms to act honestly, fairly and professionally in accordance with the best interests of their clients. CESR approach in Example 4 of its paper cannot be extended to usual and standard promotional actions (e.g. production of marketing brochures, institutional workshops, sponsorship of industry conferences or market-meetings, amongst others) carried out by asset management firms addressed to their products distributors which sole purpose is to support, help and facilitate the marketing of the product from a product provider standpoint without intention to influence or induce the investment firm behaviour to its clients. Such standard commercial promotion like actions would never be analyzed under MiFID Level 2 Article 26 in any case.

Example 5.- We agree with CESR view that such arrangement is not prohibited.

Example 6.- We do not agree that the one-off bonus scheme differs in a substantial way than what is stated under Examples 1 and 2 above; the fact that the payment is received per order, per volume or one-off bonus should, in principle, affect the qualification of the inducement. Therefore, the analysis described in Examples 1 & 2 above is fully applicable.

Example 7.- We should agree with CESR initial approach to consider such example on a case-by-case basis. Then the analysis of the particular circumstances is essential. It may be convenient to analyze this particular scenario within the discussion about softing commissions.

Example 8.- We understand that this case does not differ from Example 1 above. Therefore, the same conclusions reached above are fully applicable in this scenario.

We should draw your attention to the fact that such commissions received by the investment firm always fall under the scope of those costs and fees which necessarily apply under the purchase of a particular category of products such collective investment schemes. It is essential to understand that between the investment firm and the product provider there is an underlying contractual relationship operated via an agreement which provides the investment firm with certain duties and liabilities.

Additionally, should the investment firm properly manage any potential conflict of interest and meet the requirement to act honestly, fairly and professionally in accordance with the best interests of its clients, it is clear that such case will fall under Article 26(c) approach.

Based on the above, it is clear in the current financial markets that there are many types of fees and commissions that are a straightforward strict remuneration for real services performed, without any element which is intended to influence the recipient to act or to do anything different than provide the service is paid for. Therefore, a broad view should

be applied to “proper fees” (i.e. Art. 26 (c)), otherwise certain categories of remuneration executed for the real provision of services at the product provider and at the market intermediary level could be broken and significant market distortions as evidenced in this document would take place.

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?

Under our view, factors listed by CESR in Paragraph 26 of the paper should serve to evaluate the question of whether or not an inducement is permitted because it does not influence the investment firm behaviour which anyhow complies with the duty to act in the best interests of the client. In our opinion, CESR analysis provides for a complex combination of terms and concepts in evaluating the relevance of such factors. The fact that, through appropriate commercial agreements with third parties, IFs make available to their customers financial products and services that otherwise would not be at their disposal does, by itself, enhance the service.

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?

In our view, there are not fundamental reasons to consider useful for CESR to seek to develop guidance on the content of summary disclosures.

Broadly, CESR proposal on disclosure will probably not help investor protection. Some of the critical effects of CESR proposal on disclosure in one of the most competitive fields within the financial markets such is the current EU fund distribution market could make a breach of the confidentiality required within the relationships of management companies of products and their distributors, and the greater detail of how commissions are allocated between the different participants of the distribution channel will not ensure additional benefits to investors. Please bear in mind that this allocation has no impact on the investment returns for the investor.

To be consistent with CESR approach on disclosure confined to the UCITS product environment, we would like to analyze this matter following CESR proposal as follows:

(i) *Consistent interpretation of MiFID Vs UCITS related legislation:* It is also clear from the EU Community legislator's standpoint and, therefore, it should also be clear at CESR level in its approach on disclosure that MiFID implementation should not imply additional disclosure requirements on UCITS products (Recitals 54 & 55 of the Level 1 Directive).

(ii) *Existing regulatory framework of disclosure requirements for UCITS.* UCITS are currently regulated by the Council Directive 85/611/EEC which provides with harmonized rules to ensure more effective and more uniform protection for investors.

Such UCITS legislation in place imposes on management companies of the products with wide disclosure and information requirements to be disclosed via the UCITS prospectuses which serves as commonly-acceptable mean for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks, costs and other related issues attached thereto.

It should be made clear that a summary disclosure that is made (i) through generally available communication means – i.e. the corporate web – and (ii) with the indication of the range of inducements in place for each type of service/product is considered appropriate.

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?

We agree with CESR view. It is clear under MiFID Implementing Directive that Article 26 conditions apply in relation to fees, commissions and non-monetary benefits that can influence or induce the investment firm that has the direct relationship with the client.

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?

We agree with CESR view on such analysis.

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?

We do not have any comment on this question.

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

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

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

For Questions 11, 12 and 13 our view is the following:

Although a common supervisory approach could help, it should only be acceptable provided that is fully based on the industry accepted and well-established best practices currently in place in the most pro-industry advanced jurisdictions.

We fully disagree with CESR conclusions about the negative impacts of these types of arrangements which under CESR's view lead to overtrading, poorer execution and over-consumption of non-execution services. We feel that CESR approach is misleading requires further study and research closed to market forces and trends.