Consultation Paper on Inducements: BNP Paribas Asset management contribution

Dear Mr Demarigny,

We appreciate that Cesr has given us the opportunity to comment on its Consultation Paper on inducements.

We consider this paper as one of the major documents Cesr has provided to the market since it has been constituted, given the potential and crucial consequences the paper has for our industry as well as for investor protection.

We strongly hope our comments will be taken into account, and the initial proposals will be amended accordingly.

BNP Paribas Asset management is the leading company of the BNP Paribas Group in the asset management field. This business line is, of course, organised in different entities to cope with the existing regulatory framework in no less than 9 EU countries. We also sell our funds in most of the 27 EU countries, having invested in open architecture and developed a strong network of distributors for our range of collective investment schemes, most of them UCITS. The remarks we make on the Cesr Consultation paper are made on behalf of all these entities, which manage as a whole about 300 billion euros.

We therefore consider that we have a good understanding of fund distribution, and that we are able to foresee what could be the consequences of Cesr's orientations on inducements, if they were to remain as they are. In our opinion, **Cesr** should not only adopt a more legal approach –and focus only on Articles 21 and 27 of Mifid 2 -, but **should also be aware of the structuring effects its interpretation would have on the market place and on the respective shares of the market captured by very different kinds of financial products.**

1) In that respect, it is very significant in our opinion that the Cesr Consultation paper has described only 10 situations, which <u>all</u> involve the asset management industry. Even though Mifid addresses all investment services and all investment service providers, and even though inducements policies should be designed for all of them, we are concerned by the focus which has been put on asset management. Thus, we come to the conclusion that, while "better regulation" is the existing leitmotiv of the EU regulatory authorities, we have to face **"over regulation" of activities which are already, by far, amongst the most regulated**. Because they are well known to regulators, our activities and products attract more and more regulation and constraints, while others, less transparent, remain out of the scope of regulation.

It is the first concern that the Consultation raises.

We feel also that, even though the European Commission Green and White Papers have acknowledged investment funds were widely submitted to the competition of less regulated products, and that a true problem of **"level playing field"** needed to be addressed –for itself

and also for investor protection reasons -, **the Cesr consultation paper, if not modified, will undoubtedly increase the advantage of those competing products**, namely insurance products (out of the scope of Mifid) , certificates, notes, structured products, but also deposits, receipts and probably a wide range of products.

Cesr has to be fully aware of several realities:

- To reach final investors, distribution networks are to be built, and distributors to be found; they do not work for free. It is not only the case for financial products but for any kind of product. Distribution is a service, and the cost of distribution is always borne by customers. The final price of any product or service includes the distribution cost and the functioning of distribution implies complex agreements between the distributor and the producer, whatever product sold. **If the distributor has no financial incentive to sell a product to its customers, the product will not be sold**.

- In the case of financial products, different situations can be encountered. Quite often, the producer and the distributor are the same – it is for example the case for deposits or similar products widely offered to the retail customer, or for structured products, certificates or notes which are issued by the very banks that distribute them. On the other hand, insofar as the existing regulation is in place in Europe, asset management companies are by law segregated from banks, insurance companies, and investment firms which have the relationship with the final client. The ability of asset management to sell their products fully relies on their ability to reach agreements with distributors, which are separate entities. There would not be any agreement without what Mifid considers as "inducements". **Conversely, in many cases, products competing with investment funds can be easily sold without inducement, since the same entity produces and sells these products**.

- If the way in which Mifid 2 Art.26 is interpreted leads to tighten – if not prohibit - the inducements or deems acceptable only very low levels of retrocession for funds, the unavoidable consequences would be the following ones:

  . no further interest for any distributor to sell investment funds
  . strong incentive for most distributors to sell in-house financial products
  . most of these products not being regulated at all and being characterised by a lack of transparency in many features (including their real cost for the investor who, for example, pays the margins embedded in the derivative structure without having any knowledge of it), resulting in significant drawbacks for investor protection ("Gresham effect")
  . end of "open architecture", a development recently considered as desirable by the European institutions (Commission Green Paper and White Paper, European Parliament Klinz Report…)
  . modification of the European structure of the industry, with some countries strongly involved in open architecture relationships operations being affected
  . the industry being very sensitive to the scissors effect, a lot of market players would have no other choice than disappear.

We are confident Cesr will have in mind all these risks and will adopt an approach on inducements that is more consistent with the aims of investor protection, and which would have as an objective not to increase the regulation on highly regulated products, but to establish a level playing field which favours transparent and regulated products.

2**) In the case of investment funds**, we also question the Cesr approach on inducements for more technical reasons.

a) The Cesr paper does not provide legal certainty, but adds uncertainty, since several issues are dealt with in a very broad manner which will give rise to infinite interpretations across Europe.

   It is the case for the concept of "proportionality", which is very subjective, would be differently considered by the different national authorities and would potentially lead to litigation. This point is key, because, according to Cesr's approach, a "disproportionate" commission would have to be prohibited. If Cesr leaves room for national authorities to decide, for example, which retrocession is proportionate and which one is not, distribution will become impossible in some countries.

   It is also the case with the way in which tests are described in the Cesr paper. By referring in nearly all examples of Section 25 to the concept of "likely" or "unlikely", Cesr opens the way to national transpositions or approaches which will be very restrictive and very questionable from a pure legal point of view. It should not be simply assumed that some inducements impair the duty to act in the interest of clients, or that they do not enhance the quality of service. At least, it should be the responsibility of the client and/or the regulator to prove a breach of Article 26(b)(ii) and who is responsible for the breach, all under a judge's control.

b) Indeed, the distribution of investment funds encompasses a twofold process: there is (i) a relationship between the producer and the distributor, and, (ii) a relationship between the distributor and the final investor. The legal qualification of each part of the process is key to decide what could be the impact of Article 26, which cannot be read separately from Mifid (1 or 2).

   Above all, Mifid refers to investment services and it is necessary to thoroughly consider if, when and where an investment service is provided, and which one.

   As far as the relationship between the producer and the distributor is concerned, the relevant investment service is "placement": through a contractual agreement, the fund manager asks another investment provider to "place" the shares of its fund(s). This falls under Mifid 2 article 26 (a); as a consequence, the commission paid to the placing entity is legitimate and does not need disclosure.

   Of course, in its relation with the final investors, the placing entity has to act in a professional and fair manner, and must in particular ensure the products are suitable and appropriate for each of them. But it is key to understand that the placing entity

provides a crucial service to producers which generally do not have proprietary networks.

More complex situations may appear on the other side (relationship between the distributor and the investor): the investor can, on his own initiative, decide to invest in fund shares/units and require "execution only" (article 19.6 Mifid 1); the distributor also can provide the investor with the investment service of "advisory"; or the distribution is outside this scope (no investment service at all).

We are highly concerned by the fact that Cesr would consider as an investment service a relationship which is not, in any way, formalised in a written document, and which does not give rise to fees or commissions directly charged to the investors. In fact, it is rare that an advisory service which falls within the scope of Mifid 2 article 26, and especially section (b) thereof, would be provided.

More frequent is the situation where an investor explicitly, and only on his own, makes the request to buy fund units. In that case, at least for UCITS –and also perhaps for other categories of collective investment schemes- an "execution only" service is provided, and there is no reason to prohibit fees or commission, and no reason to disclose them to the client, who makes his own investment decision.

In addition to these two very clear situations, which refer to investment services, are the informal situations where, in fact and legally speaking, no investment service is provided. We question why Mifid 2 article 26 (b) would apply to such situations.

At the very most, what these intermediaries provide to investors is recommendations. In our opinion, that activity is clearly accepted by Mifid 2 recital 39 ("the receipt by an investment firm of a commission in connection with (…) general recommendations (…) should be considered as designed to enhance the quality of the investment advice to the client"). Having in mind, of course, that these recommendations must not be, according to the same recital, biased as a result of the receipt of commissions and more generally inducements, **we urge Cesr to stick to the spirit of the recital 39 and to consider what tools could be used to avoid the occurrence of bias**.

We acknowledge that, in a small number of obvious cases, bias would clearly appear and should be prohibited. The example 7 of paragraph 25 is a good one.

But **alternative ways can be used** to avoid bias, and Mifid provides some of the tools which would be relevant. As distributors are investment service providers, they have to comply with a set of rules which are designed to cover most of the problems Mifid 2 policy on inducements aims, in fact, to address.

In our opinion, these tools should be preferred to prohibitions or to the uncertainties embedded in the current Cesr approach.

We believe that Cesr should consider all these legal issues, address the different situations in which distribution of financial products, and especially UCITS, operates, and categorize at the end of that analysis in which cases Mifid 2 article 26 (b) applies –

in our opinion, in a very small number of cases, where there is an advisory mandate given to the investment service provider.

Where Mifid 2 article 26 (b) applies, Cesr should abandon its current approach, which is based on "assumption"; and Cesr should also avoid referring to subjective tests, such as "proportionality", which would be at the origin of uncertainty and distortions.

Finally, Cesr should limit the prohibition of inducements to a very small number of truly and undisputable unacceptable situations, which would be clearly detrimental to the client's interest and/or could strongly affect him. And Cesr should give a strong signal to the national authorities to give preference to other solutions.

3) We understand that **the situations Cesr wants to consider** through its approach –even if it is highly problematic and questionable- are linked to potential conflicts of interests.

We would appreciate if Cesr recommended more traditional approaches to deal with conflicts of interests, and in that perspective, considered how, for our industry, the very issues it has in mind have been dealt with in other jurisdictions, namely in the US.

Indeed, we do not believe the SEC regulation is to be adopted as such in Europe, but it can be interesting to look at the rationale which they have adopted to face the same kind of situation, as the same problems appear everywhere across the world.

To deal with conflicts of interests, the global approach has always been –and Mifid 2 takes the necessary steps in its article 22- to identify and manage them; and, where the conflicts cannot be avoided, they should be disclosed.

Fees and commissions borne by the final investor give rise, typically, to conflicts of interest which cannot be avoided. The investor's interest would be to remove the commissions, while the provider's interest is to maximize them. The only way to manage the conflict is to disclose the fee, commissions, and, for the purpose of Cesr paper, inducements.

It has been **the approach followed by the SEC which does not prohibit inducements but requires disclosure.**

We hope that the Cesr level 3 final draft will recommend that the different regulators adopt a similar orientation, which necessitates defining who would be responsible to fulfil the disclosure duty to investors.

In our opinion, for legal as well as for practical reasons (except if reference was to be made to some very broad wording in the prospectus[1]), **the only entity which should be subject to the disclosure obligations is the advisor**:

- the potential conflicts Cesr has in mind in its Consultation Paper are conflicts which could appear at the point of sale itself, when an advisory service is provided

[1] For example, information about inducements could be made in the prospectus of an investment fund, under the fund manager's responsibility, where it would state that "the fees charged to the fund's assets include management fees and distribution fees".

- in all situations where an advisor is used, the producer has no contact with the final customer; he has no possibility to assess the suitability and the appropriateness of the product and, therefore, could not provide the customer with the relevant elements. All of these elements are provided by the advisor
- as far as inducements are concerned, these inducements may vary depending on the agreements reached between the advisor and the producer; the latter is not well placed to provide in a timely manner any element about inducements to the final investor.

Moreover, **as investment service providers, distributors are subject to a comprehensive and consistent set of provisions designed within Mifid 2 to deal with conflicts of interest and protect clients' interests:**

- obligation to establish a conflict of interest policy adapted to their activity: this makes it necessary, in the case of product distribution, to address the potential situation of bias; when that policy includes the necessary steps to comply with the firm's duty to act in the best interest of clients, it should be considered that the requirements of Mifid 2 art. 26 b (ii) are met.
- obligation to disclose that policy to clients
- obligation to implement and maintain that policy
- suitability requirements
- adequacy requirements
- responsibilities of the compliance function, covering the overall obligations under Mifid, with
- responsibilities of senior management, equally covering the overall obligations under Mifid
- obligation to establish procedures for complaints handling.

All of this context should be taken into account by Cesr, who, in our opinion, has been too focused on one single aspect of Mifid 2 - namely article 26- when dealing with inducements.

We urge Cesr to build on that ground and avoid any orientations which, as a consequence, would on a daily basis give leeway to uncertainty and, potentially, to indirect regulation of the fees and commission levels, which is not in our view the aim of financial regulation.

To summarise, Cesr should not address the conflict of interest issues it has raised through prohibitions of or limitations on inducements, since the consequences would not result in the interests of investors, whose needs of investment would otherwise be mainly channelled through unregulated products.

To address the potential conflicts of interests, preference should be given to disclosure, since inducements are the only way for producers of regulated products such as investment funds to reach the final clients. Cesr should recognise that fees and commissions, as a whole, give by

nature rise to conflicts of interest which can be – and must under Mifid be - managed through policies and disclosure.

Given the areas where conflicts of interests may appear, the responsibility of these policies and disclosures can only be on the advisor. All the products sold by a distributor should be submitted to the same requirements.

Should you like to ask us to comment this contribution or some of its parts, we will be very happy to do so, and we remain at your disposal for any in-depth discussion.

Yours sincerely,

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