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Inducements: Good and poor practices (CESR/09-958)

Response from Brewin Dolphin Limited

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We would like to extend our thanks to CESR for opening up this discussion on inducements. This is a difficult and complex area and it is important that all the issues are explored in detail to ensure that clients are able to understand the flow of payments between parties and any bias is eliminated or actively managed. We have set out our answers in the order of the questions.

Classifying payments and non-monetary benefits and setting up an organisation to be compliant

Question I: Do you agree with CESR's views about the arrangements and procedures an investment firm should set up?

We agree that:

1. Arrangements and procedures are essential for firms to fulfil their obligations on inducements and to be able to adequately demonstrate this.
2. However, due to the differences in firms' business models - their scale, complexity, nature and range of investment services and activities - it is important that flexibility of approach should be permitted. Even within a single firm, different divisions and business areas may take different approaches and have different inducement policies. Further clarification and guidance on possible approaches would be appreciated.
3. The complexity of the firms arrangements and procedures would differ depending on:
 - a. who is giving/receiving the payment or non-monetary benefit,
 - b. whether it is necessary for the provision of the service to the client and
 - c. whether the payment or benefit by its very nature gives rise to a potential conflict of interest and those firms should assess whether the payment gives rise to conflicts with the firms duty to act in the best interests of the client.
4. Further clarification on what encompasses non-monetary benefits which fall under Article 26 (b) would be beneficial.
5. Firms should establish specific responsibilities and controls, i.e. appropriate monitoring and procedures, to ensure compliance with the inducements rules and these should be the responsibility of and approved by Senior Management.
6. We agree with paragraph 38 that the Compliance function should assess on an ongoing basis the adequacy and effectiveness of measures to ensure compliance with the inducements rule and, of course, must have support from Senior Management to enable it to challenge decisions made by the business.

Question II: Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?

We agree that firms should put in place an effective inducements policy, which will ensure that firms do not just rely on their Conflicts Policy as a means of compliance with the MiFID inducements rules. This gives the function of inducements' management importance in its own right. As mentioned above, due to the complexity of some firms' business models this may pose some difficulties and it may be a time consuming process. However, we believe this to be necessary and correct.

We agree that there should be independent oversight of inducements to ensure that any conflicts of interest related to inducements are mitigated. Compliance monitoring would help to achieve this and we certainly agree that Senior Management should support Compliance in fulfilling this role.

It would be helpful to gain some clarification on whether CESR's expectations of 'specific responsibilities' extends to creating a distinct role such as that of an 'Inducements Officer' who would be responsible for compliance with the inducements policy.



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Question III: What are your comments about CESR's view that at least the general approach the investment firm is going to undertake regarding inducements (its 'inducements policy') should be approved by senior management?

We agree.

Proper fees:

Question IV: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?

We agree, as such payments comply with the two conditions outlined by CESR and are payments which:

1. Enable or are necessary for the provision of the service
2. By their nature cannot give rise to conflicts with the firm's duty to act honestly, fairly, and professionally in accordance with the best interests of the clients.

Question V: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?

We agree.

Question VI: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?

No comment

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the service provided to the client:

Question VII: Do you agree with CESR's view that in case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?

There are a number of aspects to this question which need to be explored as we do not think there is a precise yes/no answer.

Generally, we believe the payment or receipt of an ongoing nature should reflect the nature of the service for which the third party is receiving or giving the payment. For example, when an investment firm is to make a payment to a third party for the introduction of a client, the payment should be of a one-off nature where the introducer is not enhancing the service to the client on an ongoing basis.

However, where the third party is enhancing the service to the client on an ongoing basis such as an IFA who reviews the client's entire financial affairs, the receipt of an ongoing payment for the provision of this service we believe meets the MiFID requirements.

There is a different situation where an IFA advises a client on a one-off basis and the choices for remuneration are either to receive a large initial fee from the product provider or to receive a trail commission over a longer period of time. In this case we believe the second option is preferred as this encourages the adviser to give best advice and at the same time discourages churning. Furthermore the risk of misselling is mitigated by the fact that the product provider is able to clawback trail commissions paid to advisers when the product is not held for the expected period of time.



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Question VIII: Do you have any comments regarding CESR's view that measures 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?

We agree with CESR that compliance with the duty to act in the best interest of the client should 'include appropriate monitoring and controls to deal with the specific conflicts that such payments and benefits a firm provides or receives can give rise to' (page 23 para 76);

and that

'firms must also comply with the MiFID inducement rules as a separate and important piece of the regulatory framework'.(para 77)

However paragraph 78 states;

'Although many methods of conflicts management were mentioned by investment firms, not all of them would appear to be effective in managing conflicts. For example, some firms said that information about the levels of rebates from product providers was kept away from those involved in managing clients' portfolios. However, given the disclosure requirements in relation to such payments it seems unlikely that those managing client portfolios would not be able to inform themselves about the levels of rebates attached to different products. Other firms indicated that they were remunerated only by product providers and did not charge any management fee to clients whose assets are under management when they invest in a CIS. Such a measure does not appear to address conflicts that could arise due to different levels of third party payments depending on the CIS because the firm can choose to invest in products that are lucrative for itself instead of other comparable products'.

While this may be true in theory, in practice the differences in the amounts paid or received as rebates from different CIS, are very small and we do not believe they are sufficient to influence the behaviour of the client executive to the extent that they put their own interest over that of the client. It can therefore be argued that this is a theoretical risk which is highly unlikely to manifest in practice. Removing this information from those managing client portfolios might aid the management of conflicts. However, this is only possible where a firm is large enough to segregate the adviser from the person responsible for negotiating the rebates from product providers.

In some companies the levels of fees and commission are negotiated after the funds are placed on the buy list by the Research department. By ensuring that the fund picking process is kept separate it is clear that the level of payment received does not influence the decision to invest in a particular fund and that the funds are picked on the merit of their performance rather than the level of payments the firm receives in return.

Question IX: What are your comments on CESR's view that product distribution and order handling services (see §74) are two highly important instances where payments and non-monetary benefits received give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?

No comment

Question X: What are your comments on CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?

We agree with CESR that the client is likely to end up paying the costs no matter how they are charged, whether directly or indirectly. However collecting costs, such as fund picking fees or costs relating to provision of information on the financial instruments sold by the firm, by receiving trail for example, ensures that only those clients opting for that particular service are subject to such costs.



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Research is something that is immensely important to firms as it adds significantly to the quality of the service the firm provides. Remuneration for providing this service is necessary to enable firms to continue to provide this service and we believe that collecting such costs in this way is a very effective method, providing that the costs are disclosed and agreed by the client.

Additionally, it is clear that these payments paid or received do not go against the conditions which are stated on page 19 paragraph 58*. Clients are paying for the service which provides a clear benefit to them and the firm receiving the payment is in no way incentivised to behave in a way which is contrary to the best interest of the client.

As mentioned in question VIII, there is a very narrow spread in the amount of commission rebates that are paid to or by the firm. Most funds pay around 0.5% but there are some which pay 0.75%. Generally speaking, the 0.25% difference is not enough incentive for any client executive to invest in a fund on behalf of a client, which may not be in their best interest because that particular fund pays a slightly higher level of trail. However, in order to get rid of this risk, standardising the amount of trail across the whole industry would level the playing field and stop abuses from happening.

As you are aware, in the UK the FSA is embarking on its Retail Distribution Review (RDR) and one of the tenets of this is to eliminate product bias and the FSA have publicly stated its abhorrence of trail commission. It is our view that for large firms, which have an extensive research capability and are able to negotiate similar commissions across product providers, product bias is virtually eliminated. However, for smaller firms it is possible that advisers can be influenced to a material extent by the levels of commission offered by the product provider. It is therefore appropriate to apply controls and measures with flexibility to suit different firm sizes and business models.

*Paragraph 58 states; Conditions for permissible 3rd party payments and non-monetary benefits in Article 26(b) (ii) of the Level 2 Directive are designed to prevent client detriment arising from potential conflicts of interest arising from such payments and benefits seeking to ensure that;

1. clients do not end up funding the purchase of goods and services by an investment firm which benefit the firm and not themselves
2. the firm does not have a financial incentive to act in a way which is contrary to the best interest of the client

Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure:

Question XI: Do you have any comments on CESR's views about summary disclosures (including when they should be made)?

We agree that;

- 1) a generic disclosure referring to the fact that the firm may receive inducements is insufficient to enable the investor to fully appreciate how the charging arrangements work;
- 2) such disclosure does not meet the '*essential terms of arrangements*' as per Article 26 of the Level 2 Directive;
- 3) where one or more investment firms are involved in the distribution process, each entity must comply with the obligation to disclose to its clients adequately in relation to the services that it provides;
- 4) all disclosures should comply with Article 19(2) and should be '*clear, fair and not misleading*'. Where this relates to third party payments made or received by the investment firm the information should at least include a reasonable band range of payments;
- 5) summary disclosures should be made at the outset of the relationship and prior to provision of any service as it can be difficult to disclose precise amounts for tradable investments that are forward priced;
- 6) summary disclosures should inform the client of their right to ask for further detailed information by way of a detailed disclosure;
- 7) disclosures should be made in a medium that is fair to the client and that allows the competent authority to monitor compliance with the MiFID inducement rules and that it would be good practice to use a durable medium.

By way of example, in the UK firms can comply with the rules on summary disclosure by applying certain rules set by the FSA. Specifically, FSA Handbook rules COBS 2.3.2R and 6.3.3G(4)(a) allow for disclosure via provision of documents known as the 'Services and costs disclosure document' and 'Combined initial disclosure document'.



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Having studied CESR's good practice examples we are concerned that these documents may not contain the level of detail that CESR expects. We would appreciate clarification on whether UK firm's compliance with the UK rules meets CESR's expectations and is in line with other Member States.

Question XII: What are your comments on CESR's views about detailed disclosures?

We agree that the client should have access to detailed information should they require it. However we would require more clarification on whether the '*exact amount of third party payments*' must be expressed in percentage or cash terms. We do not believe it practical for CESR to expect firms to disclose the exact actual amount payable prior to the provision of service. Exact amounts may not be possible for forward priced investments. Additionally, where funds are held in nominee name the product provider calculates the trail commission based on the net amount of the fund held at a set time. However, throughout the period the holdings within the nominee will fluctuate. This makes calculating the exact amount of trail commission received per client quite an onerous task. In such cases notifying the client of the percentage amount should suffice.

Question XIII: Do you have any comments on CESR's views on the use of bands?

No comment

Question XIV: Do you agree with CESR's views on the documentation through which disclosures are made?

Agree.

Question XV: Do you agree with CESR's views on the difference of treatment between retail and professional clients?

Agree

Thank you for the opportunity to respond to this paper. If you have any questions on our response please do not hesitate to contact us directly.