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To:

Committee of European Securities Regulators

11-13 avenue de Friedland
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Response to the CESR Consultation “Inducements under MiFID”

(Ref. CESR 06/687)

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Initial Comments on the Scope of Art. 26(c); Paragraphs 5 and 6 CP

At the outset, we think it is important to note that the scope of Article 26(c) is wide: Article 26(c) makes an exception in respect of “proper fees which enable or are necessary for the provision of investment services”.

We do not agree that this is narrow in scope as CESR has suggested, and consider that what is meant by proper fees that enable or are necessary for the provision of investment services is a clearly understood concept.

Moreover, the examples given “such as” custody costs, settlement and exchange fees are simply examples which CESR is right to identify as not being exhaustive. In particular, standard commissions or fees can clearly be characterised as payments which enable the provision of investment services since firms engaging in various types of investment activity will provide those services on the basis of commissions.

Whilst Article 26(c) does make clear that the relevant fees must not, by their nature, give rise to conflicts, we do not think that it is right to suggest that standard commissions or fees will per se and automatically fall outside the scope of proper fees within Article 26(c). It is only where their nature, the circumstances in which they are being paid or would not be paid, and in particular, their amount, gives rise to a conflict of the firm’s duty that they fall outside the scope of 26(c). Each such commission or fee needs to be looked at on a case by case basis to see whether its nature is such as to give rise to a conflict. This is consistent with the approach adopted in Article 21.

General explanation and relationship with conflicts of interest

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?

No comments.

On article 26(c), see above.

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?

In our view the following two categories of items do not fall under Article 26. Potential conflicts of interest triggered by any such items have to be addressed under Article 21.

- a. Following the wording of Article 26, only fees, commissions and non-monetary benefits that are paid or received *in relation to the provision of a service to the client* fall within the scope of Article 26. Only in those circumstances is it then necessary to go on to determine whether they fall within the prohibition on inducements, or are excluded under one or more of Article 26 (a) - (c). Such items that have no direct or indirect influence on the services rendered by the firm to the client are not to be regarded as being provided "in relation to the provision of a service to the client" and hence fall outside Article 26.

An example of a payment that in our view is not caught by Article 26 is a one-off commission paid by a firm to a third party to compensate that third party for having introduced a new client to the firm. We do not see any relevant relation or connection between a simple commission paid by the firm to the third party that introduced the new client and the services subsequently rendered by the firm to the newly acquired client. Such one-off commissions are paid to compensate the third party for its introductory efforts taking place before the client enters into a relationship with the firm.

- b. We agree with CESR's statement made under paragraph (2) that Article 26 does not concern payments made within the investment firm. **Internal arrangements under which one department of a firm (e.g. the one in charge of the establishment and management of collective investment schemes) is allocating revenues to another department (e.g. the one responsible for the distribution of financial instruments to clients) are not caught by Article 26 but have to be addressed by firms under Article 21.** If a client invests into an e.g. a collective investment scheme of a company, the total expense ratio (TER) directly paid by the client is already fully transparent. Group internal revenue allocation respectively sharing afterwards is not caught by Article 26 but have to be addressed by firms under Article 21.

In our view, the same must be true for payments between a parent company and its branches or different branches of the same firm. Legally speaking branches form part of the parent company and are therefore not to be regarded as third parties under Article 26.

Article 26 (a): items "provided to or by the client"

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"?

We agree that paragraph (12) and (13) of the consultation paper contain obvious examples of payments by the client / by a person on behalf of the client. However, Article 26(a) does not require there to be an explicit instruction by the client. It should be interpreted as covering all and any circumstances where the payer or receiver is the client, or is a person who acts on the client's behalf. We do not believe it is correct to say this will only apply in fairly restrictive circumstances; it will apply where the criteria are fulfilled.

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"?

We do not think it appropriate to seek to limit Article 26(a) to the obvious examples given in paragraph (12) and (13). There may be other circumstances where an item should be treated as paid or received on behalf of the client.

CESR does not provide guidance on the question of whether a firm itself is to be regarded as representing the "person acting on behalf of the client" in a situation where the client instructs the firm to pay or receive benefits to or from a third party. The client may wish to instruct the firm - on a fully informed basis - to pay or receive items to or from a third party. We think that the wording of Article 26(a) allows firms in such a situation to rely on Article 26(a) when paying or receiving items in accordance with the client's instruction.

Article 26(b): conditions on third party receipts and payments

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

Paragraph 19

- In our view the term "designed to enhance the quality of the relevant service to the client" should be given a broad interpretation. For example, the fact that the inducement enables the service to be provided at all, or at a cost to the client which would not otherwise be made available to the client (or at least not at that lower cost), should be taken to represent an enhancement of its quality.
- Whilst we share CESR's understanding that for items to be permitted under Article 26(b) they have to be designed to create a benefit to the client in relation to the service provided to the client, it should be emphasised that Article 26(b) does not require firms to demonstrate that there is an actual benefit to a specific client. For clarification of our position, please see the following chart:

Requirement under Article 26(b)	CESR's interpretation	UBS's comments
Item must be designed to enhance the quality of the relevant service to the client	A permitted item must relate to the service provided to the client and not to some other service.	We agree to this assessment.
	There must be a benefit to the client in relation to that service and not just to the investment firm.	Article 26(b) requires an item to be <i>designed to create</i> a benefit to the client. Firms are under no obligation to demonstrate that there is an actual benefit in each case with respect to a specific service rendered to a specific client.
	There must be benefit to the client in relation to that service and not just to other clients.	Cf. comments above. In addition, we do not agree that there is a requirement under Article 26(b) for firms to demonstrate that the item is designed to create a benefit <i>to an individual client</i> . In our view it is sufficient if the item is designed to create a benefit to the group of clients to which a particular service is provided.

Example 3 and Example 7

Choosing a particular broker because it is providing or receiving fees, commissions and other non-monetary benefits does not seem to be compatible with the firm's obligation to provide best execution (as defined by the relevant MiFID provisions) to its clients. The best execution factors as defined in Article 21(1) MiFID do not include the level of benefits the firm may receive from a broker. When providing execution services to retail clients, total consideration (price and cost) has to be the predominant execution factor. We understand that under the MiFID rules on best execution a firm is not permitted to choose a more expensive broker for the sole reason that the broker has offered to provide fees, commissions or other non-monetary benefits to the firm. We therefore believe that examples 3 and 7 are covered by the MiFID rules on best execution and that situations described in those examples should not occur in a firm that complies with these rules.

Example 4

We do not consider the geographical location of education sessions to be the decisive factor in assessing whether or not the firm acts in the best interest of the client when participating in such sessions. In our view an overall assessment of the circumstances is necessary. This should include, but not be limited to the location where the session takes place. In particular, firms should be permitted to participate in education sessions taking place outside its own premises if the totality of the circumstances does not give rise to a conflict of interest that is detrimental to the client's interest.

We would, however, recommend leaving the second example of exotic holiday locations as an example of non-compliance with the Article 27(b) requirements.[we suggest that this paragraph is not needed as the previous paragraph sufficiently covers the point.]

Example 5

In our view, example 5 contains two cases that need to be treated differently.

- a. Items that are paid to firm G on a continuous/repeat basis (such as a share of the dealing commission or management fee that is charged to the client by firm F): We agree that such payments have to comply with the requirements of Article 26(b).
- b. One-off payments that are paid to firm G in respect of successfully introducing a client to firm F: As pointed out under question 1 above we do not consider such payments falling under Article 26 because we do not see a relevant relation between the fee paid by firm F to firm G and the services rendered by firm F to the client.

Example 8

- We do not agree that commissions paid by a product provider to a portfolio manager will only meet the requirement of Article 26(b) in exceptional circumstances. In our view payments received from product providers should ordinarily be regarded as being designed to enhance to quality of the portfolio management services rendered to the client.

Commissions received from product providers form an integral part of the total compensation the portfolio manager takes for the provision of its services to the client. Total compensation consists of the management fees paid to the portfolio manager directly by the client on the one hand and payments received from the various product providers on the other. If portfolio managers were not permitted to receive payments from product providers they would have to compensate that loss by an increase of the management fee they charge directly to the client..

We therefore think that payments from product providers should be considered as being designed to provide a benefit to the client whenever a portfolio manager is able to demonstrate that its investment decisions are unbiased. This is the mechanism foreseen by recital 39 with regard to investment advice and general recommendations. In our view there is no reason why portfolio management should be treated differently under recital 39 than investment advice and general recommendations. The recital 39 mechanisms should also be available to firms rendering portfolio management.

- Example 8 seems to imply that the selection of funds (as an asset class) may be dictated by the additional payments receivable. In most cases the portfolio performance, investment objectives and risk profile will dictate the use of funds and the extent to which these are employed in the management of that portfolio. We would suggest that portfolio managers must be able to demonstrate that their investment arrangements are not influenced by incentives or conflicts of interest and that rather than the inclusion of UCITS being justifiable only on an exceptional basis (where the management company makes a fee or commission payment to the portfolio manager), it should be left to the firm to demonstrate that no inducement or conflict has arisen as the result of such activity and that it has acted in the best interests of its clients.

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?

Factor (iii)

Article 26(b) provides that the payment of a fee or commission must not impair compliance with the firm's duty to act in the best interests of the client. CESR's approach to this requirement under factor (iii) is to compare the benefit received by the client with the benefit received by the investment firm to determine whether the firm's benefit is proportionate.

CESR suggests in Sections 22 and 25 that some form of proportionality test must be applied by the firm to demonstrate compliance with its duty to act in the best interest of the client. However, it is not clear whether CESR is suggesting a complex comparison between third party payments received and the tangible and intangible value of the services received by the client (section 22) or a comparison of those payments received with similar amounts received by competitor firms in the market place (section 25).

It is our view that Article 26(b) does not form a sufficient legal basis for the proportionality tests suggested by CESR. We also believe that such tests would not be feasible in practice and that they would not achieve their objective.

In our view, Art. 26(b) is intended to achieve the effective management of potential conflicts of interest that may result from commissions paid or received by a firm. It is up to each firm to demonstrate that any third party payment it receives does not create a conflict of interest with its duty to act in the interest of its clients. However, we feel it should be left to each firm to determine the best way to satisfy this requirement and do not agree that this provision should be interpreted to mean a proportionality test must be applied. We believe that in practice it will not be possible to quantify the benefit received by the firm and the one received by the client. The proportionality test will fail in most cases because it will not be possible to assess and quantify the relevant factors.

In summary we do not consider a proportionality test to be the right approach to address the firm's duty to act in the best interest of the client. It is our view that CESR should leave it to firms to ensure that commissions and fees paid or received do not negatively affect the best interest of the client and that a more detailed interpretation of this requirement is not required.

Article 26(b): disclosure

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?

We agree with this assessment.

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 this assessment.

Tied agents

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?

Question 10: Are there any other issues in relation to Article 26 and tied agents that it would be helpful for CESR to consider?

No comment.

Softing and bundling arrangements

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?

Choosing a broker because it would provide "softed" goods or services is not in line with the firm's obligation to provide best execution (as defined by MiFID) to its clients. For retail clients where total consideration (price and cost) is the predominant execution factor, the firm may not choose a more expensive broker just because it has entered into soft commission arrangement with that broker. From a best execution point of view, unbundling seems to be the only way to deal with these concerns.

We think that CESR's guidance would be helpful to clarify the correlation of the MiFID rules on best execution and those on inducements.

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