Z E N T R A L E R K R E D I T A U S S C H U S S

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Zentraler Kreditausschuss
Comments on the CESR Consultation Paper
"Inducements under MiFID"

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The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for the mortgage banks. Collectively, they represent more than 2300 banks.

I. General points

We would like to thank CESR for this opportunity to comment on the current consultation paper entitled “Inducements under MiFID“. Even though we consider many aspects of the principles of interpretation and application contained therein to be appropriate, we are critical of several key issues. Only a fundamental revision would ensure compliance with the restrictions set up by Level 1 and 2 of MiFID as well as pragmatic application of the regulations.

To begin with we would like to point out four issues that we consider to be in need of revision:

- We object to the consultation paper’s restrictive interpretation of Art. 26 a) Implementing Directive (2006/73/EC - **“ID”**) that is inconsistent with Art. 26 a ID. We particularly object to this interpretation insofar as one of the main implementation cases of Art. 26 a) ID is not mentioned and any proviso of the categorisation of circumstances by the national civil legal systems is absent. Consequently, the most important example of a concrete pricing agreement made between an investment firm and its client has not been mentioned at all. In this context it is absolutely irrelevant whether it is the client who transfers the money to the investment firm or whether a third party fulfils this obligation (even an additional agreement with the third party is not relevant in this context). Whether such a case is classified under national law as “paid by the client“ or “paid on behalf of the client“ depends on the respective national civil code.

- As regards the admissibility of an inducement (Art. 26 b) ID), CESR is obviously basing its argument on the fact that a direct connection exists between the actual inducement and the enhancement of a certain investment service provided to a client. We strictly reject this interpretation insofar as, according to the Implementation Directive, inducements must be designed to enhance the quality of all services offered by the investment firm. Furthermore, in practice such an interpretation would lead to impracticable requirements.

- In addition, the interpretation promulgated by CESR in the consultation paper, which almost elevates the proportionality of an inducement’s material value in relation to the value of an investment service provided to a client to the level of an unwritten prerequisite for admissibility in the context of Art. 26 b and Recital 39 ID, is inconsistent with Level 2. On the one hand, in methodological terms it is not evident which MiFID regulation (2004/39/EC) or regulation under the Implementing Directive this criterion is to be derived from. Consequently, to begin with, there is no legal basis for such an interpretation. On the other hand, in practice it would be rather difficult to determine whether and when an inducement is “disproportionate“ according to this definition. Consequently, any statements by CESR that amount to an obligation by the

institutions to determine the proportionality of an inducement agreement or the provision of inducements must be avoided at all costs.

- According to the provisions under MiFID the payment or receipt of inducements may not induce the investment firm to act other than in accordance with the best interests of its clients. However, this does not mean that a possible infringement of any supervisory provision that serves to protect the interests of the client renders the payment of inducements unrelated to said supervisory provision inadmissible. In this respect MiFID / the Implementing Directive fail to establish a connection between Art. 21 ID and Art. 26 ID. However, the deliberations of CESR obviously aim in this direction, in particular as regards possible infringements of conflict of interest management provisions (Art. 21 ID). In the interest of legal certainty, this area is in urgent need of correction.

II. Replies to the CESR's individual questions

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?

Even transparent fee agreements concluded with the client and the associated payments that the national civil codes may classify as client payments must be recognized as legitimate payments.

Furthermore, finder's fees that are paid for the acquisition of clients, but not for the provision of certain investment services do not qualify as inducements. A connection with a concrete investment service does not exist.

In addition we are of the opinion that the following issue needs to be clarified: para. 3 mentions the "concept of relevant persons" in connection with Art. 26 ID. However, as regards recipients, Art 26 ID is based on payments by/to investment firms as opposed to natural persons. Consequently, further clarification is needed regarding the cases in which a connection between inducements to natural persons and the investment services provided by the investment firm is to be assumed. Tied agents do not constitute third parties but are assimilated to the investment firm. Hence, the salient point is the question whether or not the investment firm receives inducements and not whether these inducements are transferred partially or entirely to the tied agent.

To help understanding the interaction of the various cases and its conditions of Art. 26 ID, the first sentence of para. 7 should read:

"Fees and other benefits that are paid or provided to or by a third party <u>in relation to the provision of an investment or ancillary service to the client</u> and are not "proper fees"

pursuant to Art. 26 (c) are dealt with under Art. 26 (b). Unlike payments to and receipts from clients or on behalf of 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?

In our opinion, Articles 21 and 26 ID relate to different regulatory spheres. Their scope of application partially overlaps insofar as the issue of inducements is concerned. However, it is incorrect to conclude that a fulfilment of the obligations under Art. 21 ID is a prerequisite for the admissibility of the receipt/payment of inducements according to Art. 26 ID. Otherwise, any deficiency in the conflict of interest management system regarding inducements (Art. 21 ID) that is detected by the responsible supervisory authority would lead to the general inadmissibility of all inducements. This cannot be aim of the Directive. On the contrary, Art. 26 ID represents a special provision pertaining to the admissibility of inducements. This should be made clear in para. 9 and 20.

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"?

As outlined the current wording does not comply with Art. 26 a). This is due to the statement that Art. 26 a) applies only in limited circumstances and also to the fact that the important case of pricing agreement is not mentioned. In addition, whether a payment will be qualified either "by the client" or "on behalf of the client" under national civil law cannot be established by CESR. This should be highlighted in the paper in order to avoid legal uncertainty. Therefore it is indispensable that possible price agreements under civil law are not interfered with. Under civil law it is e.g. permitted that the client agrees with the investment firm parties on pricing clauses pursuant to which part of the payment is paid in cash directly by the customer and part is paid by third parties. In effect, the financial position of the parties to the agreement is exactly the same as if the investment firm, e.g. a portfolio manager, had first transferred the payments by third parties to the customer, who would then, however, be required to pay back the amount to the portfolio manager. To streamline this process, a simplified payment method has evolved (brevi manu traditio). This is one of the possible cases of payments provided by the client if the client agrees on such a pricing clause. If this method is applied, civil law requires the client to be aware of the overall costs. In such cases the investment firm is therefore obliged to disclose the amount of benefits received by third parties to the client in a statement of account.

Portfolio managers in Germany expect such practice to continue and ask to confirm it by adding a further paragraph as well as an amendment of Example 8. This would also help to avoid civil law and supervisory regulation to diverge. We suggest the following wording:

"Investment firms are not prohibited from receiving fees, commissions or non-monetary benefits if such payments are the result of transparent pricing agreements with the customer. For example, a customer and the investment firm or the portfolio manager may

agree on pricing clauses pursuant to which part of the payment is paid in cash directly by the customer and part is paid by third parties. By choosing the payment method “brevi manu tradition” the investment firm does not need to transfer payments made by third parties to the customer, who then, however, would be required to pay back the amount to the portfolio manager.”

Furthermore, we object to the narrow interpretation of Art. 26 a) ID as expressed in para. 12, which ignores the content of Recital 39/40 ID: The grounds on which Art. 26 a) should rule out contractual agreements between investment firms and third parties or require a contractual relationship between client and third party are not evident. Due to the differences in national laws, the question in which relation, “paid by the client“ or „acting on behalf of the client“, any legal relationship under civil law must exist or may not exist must be conclusively answered by the respective national legislations.

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 outlined above, pricing agreements which include partly payments of third parties, should fall under Art. 26 a). Due to the wording of Art. 26 a) and due to the different civil law regimes exact and final guidance on a European level is not helpful. This should be clearly stated.

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

In para. 16 we suggest the following wording: “Items that are not “proper fees that are paid to the investment firm by a third party (or which the investment firm pays to a third party) and not the client or on behalf of the client are dealt with under Art. 26 (b). Unlike payments to and receipts from clients or on behalf of clients …”

That would also make clear that example 8 would have to be judged differently if the client and the portfolio manager would have agreed on pricing clauses and e.g. a “brevi manu traditio”.

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?

In general, the consultation paper elevates the proportionality of the inducement's material value in relation to the value of the investment service provided to the client to an unwritten prerequisite for admissibility in the context of Art. 26 b ID and Recital 39 ID. We consider this to be inappropriate. On the one hand, in methodological terms, it is not evident what this criterion is based on. On the other hand, in practice it would be difficult to determine whether and when an inducement is "disproportionate" according to this definition.

Para. 19 illustrates the point that CESR intends to base the requirement of an enhancement in quality on the connection between a concrete inducement and a concrete investment service provided to a client. However, in practice it is almost impossible to prove the existence of such a connection. For example, it is not possible to establish a direct link between training, expert conferences, organised exchanges of experience and workshops on the one hand and a concrete enhancement in the quality of investment advice across various financial instruments on the other. Similar difficulties arise in the case of monetary inducements. Some infrastructure investments affect a whole batch of investment services while only a few actually affect individual services.

Furthermore, the required connection between a concrete inducement and a concrete investment service provided to a client is irreconcilable with the wording of the Implementing Directive ("designed to enhance"): According to the Directive, inducements must merely be designed to enhance the quality of the services offered by the investment firm.

Para. 20 contains an incorrect rendition of the Directive insofar as it presents all obligations under the MiFID, in particular the general obligation to act in accordance with the best interests of the client, as prerequisites for the admissibility of inducements. The Implementing Directive does not provide for this concept. In addition, this interpretation could lead to substantial problems where the provision of evidence under civil law is concerned.

Para. 23 subpara. 2 last sentence: Again, CESR goes beyond the MiFID requirements which base the admissibility test on the "design and objectives of the payment" as opposed to "the use that effectively is made of them". Hence, these last few words should be removed. The fact that para. 23 is inconsistent with the intention of the European legislator is also illustrated by following aspect: In the original draft Implementing Directive of 6 February 2006, an actual enhancement of quality was required ("must enhance the quality"). The European legislator deliberately dropped this requirement and now only requires the intention of an enhancement in quality ("must be designed to enhance the quality").

The statement in para. 24, which refers to the importance of various criteria to the implementation of the test according to Art. 26 b) ID in connection with "investment advice"

and “portfolio management“ services, is contradictory and should be removed. Especially in the case of these services, the refutable assumption applies that inducements made in this connection are designed to enhance the quality of service provision. To accord particular importance to the proportionality test considered by CESR in this area contradicts the fundamental principle of the above-mentioned assumption provision.

With reference to **Example 1** we emphatically state that the requirement regarding the proportionality of the inducement’s material value has no basis in the Implementing Directive and exceeds the requirements under Art. 26 b and Recital 39 ID. We consider this to be inappropriate.

In **Example 2**, the admissibility of payments to portfolio managers is denied without stating the underlying civil law situation. A protection requirement relating to the end client is absent if the payments made to a portfolio manager are disclosed to the end client and are agreed as part of the fees payable by the latter. Insofar, this example should either be removed or the third paragraph should be reworded as follows:

> „Whether the arrangement entered into by the investment firm is designed to enhance the quality of the service for the clients depends on the circumstances. If the payment the portfolio manager receives is paid to the client or if a brevi manu traditio-clause has been entered into, an incentive to act contrary to the clients interests cannot be discerned.“

As regards **Example 4**, we would like to make the general point that the requirement regarding the proportionality of the inducement’s material value has no basis in the Implementing Directive and exceeds the requirements under Art. 26 b and Recital 39 ID.
As regards the concrete example, we would like to point out that the actual location of the training measure (whether hotel or supplier) cannot be decisive provided that the training measure exclusively fulfils the requirements specified explicitly in Art. 26 ID.

In **Example 5** it should be clarified that pure finder fees which are not connected to a specific investment service and are paid for the acquisition of a client do not fall within Art. 26 ID.

Example 6 is based on Example 1 and the assumptions of Recital 39 apply once again. Consequently, the issue at hand is the question whether or not the advice is “not biased” as required by Recital 39. Sentence 1 of the second paragraph of Example 6 should therefore be removed. The assessment in Example 6 is only acceptable insofar as the binding specification of target sales is referred to. The possible inclusion of sales-related elements corresponds to current market mechanisms.

Re **Example 8**: We refer you to our comments regarding questions 3 and 5.

Para. 26: We would like to make the following comments regarding the factors listed under (i) to (vi):

(i) In the context of the assessment of inducements, additional obligations by the investment firm that go beyond Art. 26 ID should not be decisive.

(ii) + (iii) Furthermore, neither the extent of the enhancement in quality nor the proportionality of the enhancement in quality in relation to the inducement should be decisive. There is no legal basis for this additional prerequisite.

(v) This should not be decisive, instead the point should be whether this impairs the investment firm's ability to act in the best interests of its client. In other words: The temptation to act other than in the client's interests as such is irrelevant if the investment firm does not give in to the temptation.

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?

Having regard to the different civil law systems in the member states, we do not share the view that such an initiative would be helpful. Hence we support the assessment made by CESR (para. 31).

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?

Para. 37 discusses circumvention of the inducement prohibition via "special purpose vehicles" (SPVs). However, in categorically prohibiting the establishment of any SPVs, the last sentence under para. 37 goes beyond a circumvention prohibition. Hence, it should be reworded as follows: "These would have the effect of prohibiting such arrangements or of ensuring that the investment firm disclose the amounts to the client if the pertinent conditions of Art. 26 ID are met."

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?

As outlined, a tied agent is a "relevant person" and as such not a third party. Therefore payments by investment companies to its tied agents should not be regarded as fees or commissions pursuant to Art. 26 ID. It should be sufficient to mention the part in the policy (conflicts of interest policy) that tied agents receive fees and commissions (e.g. sales agents´ commissions - "Handelsvertreterprovisionen").

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.

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

As regards para. 42, the existence of bundling arrangements does not exclude the possibility that the investment firm will seek clarity regarding the costs of the service received (including the softed services). Hence, in answer to question 11, we would like to state that Art. 26 ID does not fundamentally challenge the existence of current softing and bundling arrangements.

III. Editorial comments

In failing to make a clear distinction between Art. 26 a) and Art. 26 b) ID, the consultation paper oversteps the MiFID guidelines. Various examples, which describe the prerequisites of Art. 26 b) ID and do not apply to Art. 26 a) ID, incorrectly contain general references to the complete Art. 26 ID.

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