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Response to CESR's Consultation on Inducements: Good and Poor Practices

Key Points

- **Banks overall believe that the consultation paper reflects current market practice.**
- **However, it must be clear that CESR's report can only have the status of guidelines and is not intended to undermine flexibility for specific situations. Arrangements resembling those described as "poor practice" in the consultation paper should not automatically be considered objectionable.**
- **Neither does current market practice require any additional rules. Experience shows that clients are overall satisfied with the type and amount of information they receive.**
- **It should be left to firms to freely design internal compliance arrangements. Also, compliance arrangements have to be seen in their entirety.**
- **With regard to CESR's specific examples, banks object in particular to the views that ongoing payments in connection with services of a one-off nature are problematic or that the splitting of information between different documents should be considered poor practice.**

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General remarks

The European Banking Federation (EBF) overall finds CESR's draft report on good and poor practices of complying with the MiFID's inducement rules agreeable. Banks would concur with most of the examples given by CESR and their respective classification, and feel that these **descriptions overall reflect well the way in which the inducements rules have been implemented.**

In this context, it is banks' experience that **clients are overall satisfied with the information they currently receive on inducements**, in accordance with the MiFID rules. For example, as CESR states itself it is rare for clients to ask for more detailed information, after having received summary information. The EBF is therefore surprised about CESR's statement that this consultation paper is "a response to calls from the industry and investors for CESR to pursue further work to ensure a common and consistent interpretation and application of the MiFID inducement rules".

Banks also believe that the approach taken by CESR, of providing examples, points to the difficulties of establishing any more detailed rules on inducements. Circumstances indeed have to be assessed case-by-case.

As a result of the nature of CESR's paper, there is in addition a concern about the lack of clarity, where statements seem prescriptive for specific situations but cannot easily be translated into their operational reality in a more generalised way. It is therefore important to **stress that CESR's document merely provides guidance** and that arrangements that resemble those described as "poor practice" in the consultation paper would not automatically be considered objectionable. Similarly, the EBF is unclear about CESR's remark on page 6, section 8, regarding poor practices which in CESR's opinion would "lead a firm to be in breach of the MiFID inducement rules". It would be welcome that CESR clarify it does not intend to set limitations to current practices which are in accordance with MiFID.

Besides, banks would suggest that CESR should be mindful of the principle of proportionality when formulating inducements disclosure guidelines. Inducement disclosures should not be seen as an end in themselves, but rather as background information relevant to investors to further inform their decision-making process.

It has also been noted that CESR seems to describe inducement rules exclusively in situations where inducements are being used in a specific transaction; and not where they are used in, for example, a series of transactions. CESR should be aware that the approach taken in its consultation document does not suit all market practices.

EBF members also consider that it should be clearly left to firms themselves to handle specific questions of internal compliance.

Finally, it would add clarity to CESR's consultation paper to spell out more clearly that inducements under Article 26 only cover payments made in connection with the provision of investment or ancillary services to the client, rather than any kind of payments.

Responses to CESR's specific questions

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

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

The EBF overall feels that CESR's descriptions are relevant. The Federation also agrees with the views expressed by the Committee regarding the internal arrangements that should be set up by investment firms to comply with the inducement rules, although the specific design of such arrangements should be left to firms. Importantly, the EBF notes that the flexibility that currently exists for firms to adopt approaches that fit the nature and size of their business is essential and needs to be maintained.

There is however a view CESR should be mindful of the principle of proportionality in formulating its requirements about investment firms' internal arrangements and procedures. Accordingly, when payments are of an insignificant size and frequency the requirements should be less stringent than for larger payments, in order to avoid an exaggerated administrative burden that would not stand in any proportion with the added value in terms of investor protection.

Furthermore, as regards the "identification of payments and non-monetary benefits", CESR identifies as poor practice that "(a)n investment firm's internal procedures are able to single out, from all payments and non-monetary benefits traced, only those falling under Article 26(b) of the Level 2 Directive".

However, payments that fall under 26(b) are the only ones that require further analysis with regard to their acceptability or the need for additional measures (in particular disclosure). For other payments, no further action is required. It is therefore unclear to the EBF why the singling out of payments that fall under Article 26(b) would be considered poor practice.

Also, it is the EBF's understanding that the regulatory obligations under §36 of CESR's consultation document are limited to situations where inducements are received, and that the payment of inducements is covered by institutions' conflict of interest policy. According confirmation by CESR would be welcome.

2. 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?

It must be borne in mind that inducement rules are only one part of banks' entire compliance policy. Overall compliance policy is much broader than just that of respecting the inducement rules. It also includes, for example, market abuse rules and requirements for the segregation of assets. While banks clearly have to develop a compliance policy that also takes due account of the inducement rules, this has been done individually by each bank or investment firm, in accordance with their size and nature of business.

Besides, the Federation considers exaggerated the example given by CESR on page 14, with respect to recordkeeping. CESR describes it as good practice that a firm “sets up specific arrangements and procedures to be able to record and track every relevant action by the firm for the purposes of the MiFID inducement rules”. For reasons of efficiency, it should be permissible to cluster similar payments and treat them in the same way, rather than dealing with each payment separately.

3. 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?

In itself, the requirement for the senior management to approve a firm's general approach to inducements, on a sufficiently generic level, seems reasonable and proportionate. However, the EBF considers that Level 3 of the Lamfalussy process has not been designed to create any new policy obligations. Firms have long developed and rolled out their MiFID compliance policies, which should only be evaluated against the MiFID Level 1 and Level 2 texts.

Proper fees

As a preliminary remark and with regard to CESR's paragraph 48, the EBF would emphasise that it would not consider underwriting fees to fall within the scope of Article 26(b) of the Level 2 Directive. Underwriting is a service provided to the issuer, whether or not the intermediary undertakes the selling of the financial instruments issued. In the case that the underwriter also sells on the financial instrument, charges are embedded in the issue and thereby borne by all investors in proportion to their investment. However, underwriting fees are disclosed in the Prospectus Directive.

Furthermore, the compensation of tied agents should be considered in the same way as internal payments to firms' employees, which are outside the scope of the inducement rules. I.e., they should not be considered relevant for the purpose of Article 26 of the Level 2 Directive.

4. 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)?

The EBF believes that all kinds of fees paid in order to access and operate on a given execution venue should indeed be considered proper fees. The list provided on page 16 provides a number of typical examples, but should not be seen as exhaustive.

5. 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?

The EBF believes that custody-related fees should typically be considered “proper fees”.

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

A tax sales credit (TSC) is an intra-group allocation to a relationship office of a financial institution located in one jurisdiction, related to the sales activity that this office undertakes for the same institution's market-making office, located in another jurisdiction. Tax sales credits are a form of transfer pricing arrangement (TPA), put in place by institutions undertaking transactions on a cross-border basis in order to avoid double taxation. TPAs ensure that income arising from cross-border transactions is properly attributed and that there is proper accounting to the tax authorities in the relevant jurisdictions.

By this virtue, tax sales credits should typically be considered eligible for the "proper fees" regime. They "enable, or are necessary for the provision of the designated investment business or ancillary services, and, by their nature, cannot give rise to conflicts of interest with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its client". Where a tax sales credit does not meet these criteria, it should subsequently be subject to the cumulative conditions set out within Article 26(b) of MiFID.

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

7. 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?

The EBF does not agree with this view. Financial products are typically acquired with a long-term investment horizon in mind. It is normal practice in such cases that payments are made over a period of time, and banks do not believe that this would be any more problematic than a one-off payment. On the contrary, larger one-off payments could possibly create undesirable incentives to encourage more frequent client transactions. Ongoing payments, on the contrary, align the adviser's interest with those of the client, looking for suitable long-term investment products or services.

Nevertheless, the EBF cautions against attempts to classify particular payment structures as "good" or "bad". The judgement of whether a service is designed to enhance the quality of the service for the client and refrains from impairing compliance with the firm's duty to act in the best interest of the client does not depend on the way in which the payment or non-monetary benefit is delivered. CESR should therefore refrain from favouring or dictating particular structures of internal governance.

8. 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?

As noted above, the compliance function has to be seen in its entirety, rather than isolating the inducement rules from other parts of firms' compliance policies. However, it is certainly true

that effective overall compliance procedures necessarily rely on appropriate monitoring and controls. In addition, transparency towards the client on e.g. the amount, purpose and recipient of the fee is an important aspect of conflict of interest management in relation to third-party payments.

Besides, it should be borne in mind that these arrangements are in addition to other MiFID requirements such as that on “best execution” and suitability and appropriateness tests, which supplement firms’ conflict of interest management policies.

9. 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?

The EBF agrees that product distribution and order handling services can be important instances where payments and non-monetary benefits may give rise to conflicts of interest. This has overall been well recognised by firms, in their respective implementation of the MiFID inducement rules.

However, there can be alternative situations. For example, in some cases investment advisers are not aware of the payments to them that might be linked to a client investing in a certain product, or their compensation might not at all be related to the client’s investment decisions.

10. 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?

Unlike CESR the EBF believes that cost savings for the client do indeed satisfy the “designed to enhance” criterion. From the client’s perspective, there is a distinct and direct link between the quality and the cost of a service.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure
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11. Do you have any comments on CESR's views about summary disclosures (including when they should be made)?

The EBF believes that CESR’s proposals and examples are pertinent. However, the use of summary disclosures can also be market-driven, in the sense that clients prefer to receive information in this form and feel it gives them an understanding of the firm’s internal arrangements sufficient to inform their decisions. Besides, firms’ information policies in respect of inducement rules should be seen as similar to their information policies in respect of conflicts of interest, which according to MiFID can also be provided in summary form.

12. What are your comments on CESR's views about detailed disclosures?

The EBF does not have any objections to CESR's specific considerations in this respect. However, it is indeed rare for clients to request additional, detailed information to supplement the summary information.

13. Do you have any comments on CESR's views on the use of bands?

The EBF overall agrees with comments on CESR's proposals in this respect. Bands are in particular used in summary disclosures when the final level of payment cannot be calculated prior to the provision of the service. Such practice should normally be considered perfectly acceptable, naturally subject to respecting the MiFID requirements of "fair, clear and not misleading" information.

14. Do you agree with CESR's views on the documentation through which disclosures are made?

The EBF overall agrees with CESR's views but is concerned by CESR's consideration, on page 38, that the splitting of information on inducement payments between various documents should be seen as poor practice. Rather, the EBF believes that such practice is a natural consequence of other MiFID requirements. For example, when opening an account MiFID requires that the client is informed about potential conflicts of interest in relation to services provided to him. In the process of providing investment advice, as a next step, the client is to be informed about the concrete amount of benefits received by the investment firm in relation to products offered to the client, if applicable. It would therefore practically not be feasible to provide both sets of information in the same document.

On the other hand, it should be clarified that Example 2 on page 32 which states that detailed information on inducements should be given before each transaction would not be applicable for discretionary portfolio management. With discretionary portfolio management, the client opts to delegate to a third party the management of her portfolio for the very purpose of not being involved in every single transaction. Rather, portfolio management is undertaken within a specific framework agreed between the investment firm and the client. To fit this set-up, inducements disclosure should be made in a more generic or aggregate way, so as to best serve the client's interests.

Furthermore, the EBF notes CESR's own conclusion that the fact of providing information through the combination of a general document and specific documents is not necessarily an infringement with the applicable MiFID rules. In order to avoid confusing or misleading messages, the Federation would therefore suggest that Example 1 on page 38 is deleted.

The EBF does also not consider relevant the example given on page 37, of investment firms providing their clients with an "inducements calculator". Whilst agreeing that disclosure has to be sufficiently specific to be meaningful for investors, the Federation is not aware of any firms using such a "calculator" and would encourage that this example be deleted. Furthermore and as noted above, inducement disclosures should not be seen as an end in itself, but rather as background information supporting the client's investment evaluation process.

15. Do you agree with CESR's views on the difference of treatment between retail and professional clients?

The EBF agrees and concurs in particular that what constitutes fair, clear and not misleading disclosures can vary for different types of clients. In particular, professional clients are expected to have a greater depth of knowledge and experience, and are thus better placed to make their own investment decisions. It is legitimate for investment firms to draw an according, though subtle distinction between retail and professional investors when drafting summary and detailed disclosures under the MiFID inducement rules. However, investment firms servicing both retail and professional clients might use universal disclosures for both sets of clients. Therefore, the approach to disclosures may vary between firms as a whole, or between different business units of the same firm.