



EFFAS THE EUROPEAN FEDERATION
OF FINANCIAL ANALYSTS SOCIETIES

CESR
Section: "Consultations"

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Public consultation - Inducements under MiFID CESR Reference 06-687

Response by EFFAS European Federation of Financial Analysts Societies

Dear Mr Demarigny,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 24 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

We appreciate the opportunity to comment on the consultation paper on Inducements under MiFID. We would like to answer the questions as follows:

The consultation paper discusses the relation of Articles 21 and 26 of the Level 2 Implementing Directive 2006/73/EC. We believe that this discussion correctly reflects the operation and relation of these two provisions. Unfortunately, the paper mentions only very briefly the term "standard fee or commission provided for the service", but does not discuss the interpretation of this term. EFFAS is aware that the consultation paper is focused on the issues of Article 26. However, it would be helpful if the meaning of the term "standard fees and commissions" could be specified in greater detail in those recommendations. Are standard fees and commissions determined by an industry average or by any reference of general nature, or are they rather the fees and commissions which the particular investment firm has published in its general business conditions or commission schedule or other document of general nature?

In our opinion the detailed provisions of Article 26 and the explanation in the reference document seek to enhance transparency. Although this objective can be supported by the contents of Article 26, the provisions with regard to (retail) client agreements should primarily be supportive of the transparency objective. The clients and the market competition will determine what fees are sustainable. A detailed list with conditions on remuneration will not solve the issue as to what fees are tolerable. We believe that the issues mentioned in the reference document will not prove to be issues in daily practice as long as the client is aware of the fees that are charged for rendered services. For discussion purposes the reference documents should have explicitly assumed transparency to the client, e.g. through documentation and client agreements, as this is customary in our business.

Article 21 deals with the identification, avoidance and proper management of conflicts of interest. As far as the inducements are concerned, an inherent conflict of interest exists between a service provider and its client. The service provider wishes to obtain for a particular service a remuneration as high as possible, the client wants to pay as little as possible. In a functioning service market, competition will set the limits. It will be not an easy task for CESR and its member authorities to fit the concepts of standard fees and commissions and those which are “designed to enhance the quality of the relevant service” into a market system where prices are a key element of competition. We do not think that the provisions on inducement should serve as a device for price control.

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?

Response:

EFFAS agrees with the paper’s position that Article 26 applies to all and any types of fees etc. However it should be clearly stated that it does not mean that Article 26 has something to do with the level of those fees, as long as the amount is calculated in line with the rules set in Article 26.

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?

Response:

EFFAS agrees with this analysis.

Questions 3 and 4 - general discussion:

Article 26 is a provision conceived and enacted by the Commission in a regulatory setting. The fact that Article 26 employs the legislative technique of forbidding any and all inducements as a rule and creating exceptions to this rule for certain circumstances has far reaching consequences which might not have been seen or have been disregarded by the Commission, but which must be reasonably considered by those applying this provision. Article 26 disregards contractual agency relationships governed by commercial law which is partially governed by the Directive 86/653/EC on the coordination of the laws of the Member States relating to self-employed commercial agents.

Investment firms acting as intermediaries between clients and other investment service providers (full brokers, dealers, banks, management companies) can be subject to essentially three types of contractual relations:

- Intermediary acting as an agent of the investor-client. The agency contract exists between client-investor as principal and intermediary firm as agent. (See annotation 13 of the consultation paper: Investment firm A is an agent of Client B).
- Intermediary acting as an agent of another investment service provider (broker, dealer, manager). The agency contract exists between investment services provider as principal and intermediary firm as an agent (Investment firm A is an agent of Investment firm C - subcategory: tied agent).

- Intermediary as a disclosed introducing broker (German: Makler, French: Courtier, Italian: Sensale, Spanish: Corredor). The disclosed broker stands between the parties and has a neutral position with rights and obligations to both parties brought together.

Article 26 superimposes on these contractual relationships under commercial law rights, duties and prohibitions which materially modify the contractual freedom. Basically, the intermediary as a client's agent or as a neutral introducing broker is seen as the ideal. This understanding is the basis for Article 26 which treats inducements to and from the client as the regular legal relationship, and all other types as exceptions viewed with distrust. According to EFFAS' belief, the majority of intermediaries to retail investors act as agents for the ultimate investment service provider. However in some countries (e.g. the Netherlands) it is quite customary that an introducing broker "owns" the client, at least has the client relationship, and therefore is able for example to look for principal brokers who give the largest discount. Therefore the relative importance might be different in various member states.

The example of client B and firm A and B should not be made too complex. The client agreement should stipulate the payments of the fees to A and B. Also in this issue, the fees themselves are not the issue, but transparency is.

This underlying philosophy must be borne in mind when discussing the rules of guidance suggested in this consultation paper.

Article 26(a) is ambiguous, as it refers to a person acting on behalf of the client. In connection with an investment firm acting on behalf of a client, the action could refer to the service provided or to the payment made or received. The purpose of the provision makes the reference to the payment action mandatory. If this interpretation is chosen, the exception of Article 26(a) will only apply when and if the payer or payee makes or receives the payment or inducement in the name or at least for the account of the client. This rules out an interpretation to the effect that an intermediary or a portfolio manager acting on behalf of the client in rendering the investment service could receive or make inducement in his/her/its own name and own account from or to third parties and claim the exception of Article 26(a). This interpretation on a very general level should provide a clear line between those cases covered by Article 26(a) and those falling outside its application.

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"?

Response:

With the above general understanding, EFFAS' response to the question is affirmative.

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"?

Response:

See the general interpretation outlined above. Another example would be items provided to or received by persons that are acting for the client outside a professional relationship and where the provision or receipt of the item can be attributed directly to the client, e.g. parents acting for their children.

Question 5:

Do you have any comments on the CESR's analysis of the conditions on third party receipts and payments?

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?

Response:

The crux of this part of the provision lies in the requirement under (ii) that the payment must be "designed to enhance the quality of the relevant service to the client".

We believe that a restrictive interpretation of the term "designed to enhance the quality of the relevant service to the client" would be very likely to interfere with a market system where prices are a key element of competition and could therefore jeopardise a functioning service market to the detriment of both the investment industry and the clients. This is particularly true if the examples suggested by CESR were regarded as exhaustive for determining the scope of permitted inducements according to Article 26.

We do not question the legitimate intention of the paper to identify potential areas of concern. We also credit the paper with making the reservation that each case must be judged on its own merits. Yet, it is dangerous when regulatory agencies would take a preponderant negative view against payment schemes having been practised in the industry for a long time and not having been harmful to the clients in the great majority of cases.

Therefore three issues should be raised:

- Must the payment be related to a "direct" enhancement of the services rendered to client or is an "indirect" enhancement affecting the overall service quality of the firm sufficient? In other words: Must the payment relate to an individualized service to a client or not?
- Does the term "designed to" relate to a subjective good faith intention of the service provider or is this term governed by outside standards or the judgement of an outside party, i.e. some generally accepted industry standard or the regulatory authority? In other words, is the test a subjective or an objective one?
- Does "enhance" include maintaining an existing satisfactory service standard and thus preventing a lowering of the standard?

In the first issue, the consultation paper seems to take the position (annotation 19) that a payment may only be justified if the enhancement is related directly to a service rendered to a particular client and not to the firm in general. It is quite unclear whether the paper would accept a benefit to the firm indirectly enhancing the service quality vis-à-vis all clients. If this benefit were not accepted, the paper's interpretation cannot be supported.

The client of investment services is interested in the total charges levied on him/her for obtaining a greater or smaller bundle of services in a satisfactory manner. Considering the client's position, the distribution of the total cost among the different service or product providers in dividing the service functions among themselves is of secondary importance. It is insofar of interest to the client that he may better understand conflicts of interests of the investment firms involved, but the information in the client agreement should solve this issue. Apart from this information, it is rather irrelevant for him how the total cost to him is divided as revenue between those firms.

Each participating investment firm has other considerations to determine an adequate remuneration for its activities. These include cost factors, profit expectations, competitive position, client satisfaction, good will of business partners etc. Furthermore, the manner in which an investment firm has designed its management accounting system - including the cost accounting - is relevant for an assessment of allocated costs per client and therefore client pricing.

These factors are not necessarily directly related to a particular service to an individual client. Some of them are fixed, other variable, again others change with the size and complexity of the business. Many if not most of these factors have only an indirect relation to the services rendered to a particular client. Therefore, the calculation of revenue items cannot only take into account the enhancement of the quality of an individual client, but must take into account all those other factors and strive for an overall excellent service organisation insofar benefiting each and every client.

This shall be explained in context of some statements in the consultation paper. In annotation 22 the paper states: "A commission which gives disproportionate benefit to the firm relative to the value of the service provided to the client is likely to impair the firm's compliance with its duty to act in the best interest of the client. Who is going to determine whether a revenue item is disproportionate if the revenue item has been negotiated between two investment firms dividing among themselves total charges to a client which are proportionate to the total of services provided to the client? Why should the higher share of other service provider affect compliance of that firm? Or why should the lower share of the other firm negotiated between these two parties (principal firm and agent firm) negatively affect compliance of this firm? There might be a host of legitimate reasons which led to this division of the total cost charged to the client. The assumption that such a distribution would automatically lead to higher overall charges to a client without enhancing the service quality is not justified. This would be true only in the absence of competition. To assume the absence of the forces of competition in the financial markets is no basis for interpreting and applying Article 26.

Other cases for controversial discussion are examples 3 and 6 of the consultation paper. They are used to demonstrate that such arrangements are more likely not to enhance the service quality but are rather jeopardise unbiased action and should be prohibited. This conclusion could be correctly drawn if these inducement arrangements were not disclosed. If so, EFFAS would agree that there is no good faith and the intention is most likely to induce biased behaviour.

However, when such arrangements are properly disclosed in client agreements, one should assume that the firms involved have their legitimate commercial reasons to divide total income in this manner. In example 6, the paper assumes that an override tied to a certain level of sales are most likely not acceptable. This thinking overlooks the fact that the regulatory requirements depend among other elements on the size of a firm and the business transacted.

The cost to fulfil such requirements (internal control, internal audit, compliance organisation) does not increase proportionately with each additional sale. It is therefore quite legitimate that principal and agent firm agree on a higher income for agent based services on certain levels of the business. Such additional payments would have an enhancing effect on the overall quality of service to all clients.

Even commercial law on a unified European level provides for one time payments after the fact to an investment firm acting as a commercial agent for another investment firm acting as principal. Commercial agents receive at the regular end of their agency contract with a principal an indemnity for having to turn over their clientele and the potential future business to the principal firm. Such indemnity is greatly influenced by the volume of business introduced.

Although this indemnity will probably qualify as an unquestionable legal fee, it is hard to conceive that such payments would be an incentive for biased behaviour against the best interests of the client as there is not a changing investment strategy that responsible for these payments. However it should be remembered that such arrangements are disclosed to the clients.

It seems also that the paper uses different standards in evaluating the bias concerns. In discussing the treatment of inducements paid to tied agents, the paper ignores any effect of similar inducement arrangements between tied agents and principal firm due to the fact that the principal is unconditionally liable for the behaviour of its tied agents. We do not question the conclusion drawn by the paper as far as it restricts the disclosure duty to the total amount received by the principal firm, yet for other arguments (see below). But it is surprising that the paper does not discuss any risk of bias of "disproportionately" remunerated sales champions among tied agents, but distrusts widely those firms which are regulated on their own. The paper does not at all take into account the cases in which a regulated distribution firm is contractually linked to an investment product or service provider on an exclusive basis not having any other comparable product or competing service to offer, but not being a tied agent in the meaning of the directive. This is the case for a material number of firms which offer packaged products (UCITS) on the one side for some firms and have only one or few other investment services (e.g. individual portfolio management or other financial instruments) of another firm to offer. In these cases, the bias in favour of their latter principal is dictated by agency law. As long as such an arrangement does not lead to advice or introduce an unsuitable product or service to the client, the regulators should practice restraint in questioning the commission or inducement arrangements between those firms.

We think that the less controversial and more important provision in practice is the second requirement of disclosing and properly explaining the inducement arrangements to clients. Firms that properly disclose their inducement arrangements to their clients presumably have made these arrangements in good faith. It is safe to assume that these firms will be less biased to the detriment of their clients than those firms who hide these arrangements. Until proof is offered to the contrary, such arrangements should be treated as complying also with the other requirements.

This also suggests an answer to the second issue. The inducement when properly disclosed and explained is most likely made in good faith and in the intention of the investment firm designed to enhance the quality of the service offered. Therefore, we think that the design is to be judged according to the explicit or circumstantial evidence available for the particular firm showing the intentions of the firm instead of introducing a generalised and hence arbitrary outside standard.

This test is a subjective one. Firms who do not properly disclose their arrangements will fall under a general assumption that their arrangements are designed not to enhance the quality of service and pose a compliance risk, apart from the fact that they do not meet the second requirement of the provision.

An inducement arrangement is also designed to enhance the quality of the service if it operates to prevent a lowering of service standards. This term is relative in as much as it does not relate to a static environment, but rather to a dynamic process. Seen from a potential lower standard of services, an inducement preventing this risk from materialising can be regarded as enhancing the quality starting from an impending lower standard.

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?

Response:

EFFAS agrees with CESR's position. We appreciate that CESR has not established detailed guidance on the content of summary disclosures.

The provision is in itself quite clear and requires that all essential terms must be disclosed. The purpose of the provision is to force the investment firms to disclose every element of an arrangement that is available at the time of the disclosure (e.g. actual overrides to be determined after the fact cannot be disclosed at the outset of the relationship) and does not impair the value of the information for the investor. Details which are confusing, e.g. pertaining to every step in the distribution channel, and rather deflect than reflect the essence and effects of an inducement arrangement may be omitted and can be disclosed upon request. Complicated formulas might be reduced to their basics. On the other hand, and for the sake of client information and overall market transparency, generic statements should not be considered as sufficient.

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?

Response:

EFFAS agrees with CESR's approach. If fees, commissions or monetary benefits are paid between a number of entities in one distribution channel, Article 26 should apply only to those inducements that are liable to influence the intermediary with direct contact to the client. Also, the rules for summary disclosures should be applied in the way as proposed in our reply to question 7.

Nevertheless, the client agreements should determine and therefore be the basis for disclosure of arrangements.

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?

Response:

EFFAS supports the result of CESR in discussing this topic, but not for the reason that the investment firm is unconditionally responsible for any action or omission of the tied agent.

In most jurisdictions of continental Europe the investment firm is responsible for the tied agent, but as a consequence of private law and not in the meaning of this directive. It is not yet clear which impact the provision of Article 20 of Level 1 Markets in Financial Instruments Directive 2004/39/EC will have in the context of principal-agent relationships between investment firms. Therefore, presently also principal firms of non tied agents must beware of the activities of their agents at least in meeting their own obligations of proper risk management.

The reason that the inducements paid to tied agents are not the object of disclosure lies in the fact that tied agents in relation to their principals are not considered third parties in the meaning of Article 26. The concept of tied agents created in the US as guaranteed introducing brokers, taken over by the Investment Services Directive and perpetuated by MiFID is based on the notion that tied agents, albeit independent third parties for all other purposes, are assimilated to employees or dependant departments/branches of their principal investment firms for regulatory purposes. If the inducements paid to tied agents would be subject to the disclosure requirements, it would be the logical consequence to require also inducements paid by investment firms to their employees having direct contact with the client and advising on and introducing investment services or products. Both categories of advisers and introducers would have to be treated as third persons. As long as this consequence is not drawn, there is no justification to subject the inducements of tied agents to the rules of Article 26.

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?

Response:

Softing and bundling are common arrangements in the financial industry. Bundled services are covered by general rules on conflicts of interest and inducements.

One part of bundled services is the disposal of investment research. If the disposal of investment research is in the context of the fulfilment of client orders, the conditions of Art.19 MiFID and Art. 26 of the Level 2 Directive 2006/73/EC have to be met. Especially the application of Art. 26 will lead to more transparency in the future. We would like to stress at this point, that it is our clear opinion that investment research as described in Art.19 MiFID and Art. 26 of the Level 2 Directive 2006/73/EC has a positive economic value, and, therefore, the provision of such research should be regarded as inducement in cases where there is no standard price paid for this research.

At the moment, softing and bundling arrangements are regulated differently by different member states. A common supervisory approach across the EU as considered by CESR would have positive effect, especially concerning cross-border-activities, because it defines the conditions under which softing and bundling arrangements are legitim. So we generally support the intention of CESR to develop a common supervisory approach. As association representing financial analysts and asset managers, EFFAS intend to work out a policy paper on the issues revolving around investment research in the above context.

We would thus very much appreciate to work with CESR when it will start its work on that common supervisory approach.

Yours sincerely,



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Chairman of EFFAS



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