

## **IBF RESPONSE TO CESR CONSULTATION ON INDUCEMENTS**

**CESR REF: [07-228]**

April 2007

Irish Banking Federation (IBF) is the leading representative body for the banking and financial services sector in Ireland, representing over 60 member institutions, including licensed domestic and foreign banks and institutions operating in the financial marketplace here.

### **I. General Comments**

1. IBF welcomes the opportunity to comment upon CESR's recommendations on inducements under MiFID.
2. While CESR have requested that points made by industry in responses to the Consultation of December 2006 are not repeated, IBF still contends that the points made in the previous submission on inducements are still valid and a copy of that document is attached as an annex to this response.
3. IBF notes CESR's acknowledgement of points made by industry, particular in relation to its interpretation of Article 26 of Level II. IBF also notes the involvement of the European Commission and its support for CESR's interpretations on inducements. However IBF does not agree with CESR's or the Commission's interpretation, and feel that the application of Article 26 (b) of Level II should focus upon circumstances whereby payments induce firms to act in a manner that is not in the client's best interests. We would again articulate that it is disproportionate to assume as a starting point that all payments are inducements unless proved otherwise.
4. IBF supports CESR's intention to create a common European inducements regime, it is noted however that the option that national regulators retain to implement these recommendations on a voluntary basis creates uncertainty and contradicts the attempts to build a harmonised approach by leaving open the possibility of disparate and disjointed implementation of these recommendations. IBF would be opposed to these recommendations becoming additional rules.

### **II. Specific Comments**

5. IBF points to the wide scope applied by CESR to fees, commissions and non-monetary benefits that can be deemed to be inducements, and argues that this goes beyond what was intended in the Level I and Level II Directives. The consultation paper goes to great effort in highlighting a very wide range of matters that could be considered as "inducements". Firms that seek to operate properly will be open to vexatious allegations as a result, and appropriate mechanisms should exist to provide firms with appropriate protections. In particular, even the most well-designed schemes may result in a conflict of interest when situations arise that were not envisaged during their design. Firms that are willing to correct these situations should not be exposed to the allegation that they "operated improper or illegal inducement schemes", which would be highly damaging to a firm's reputation even if not upheld.

6. Well motivated firms may have processes in place whereby:

- The design of the relevant schemes are considered and approved by an appropriate person, having regard for the relevant regulations and the general operations of the firm
- Design of controls within the firm should ensure schemes operate as intended
- Relevant persons have been advised of their responsibilities under a conflicts of interest policy or similar (e.g. general code of ethics)
- Any client complaints regarding incentives are considered both in the specific case of the client and in general

7. These practices, when followed with due care and attention, should provide firms with reasonable assurance that the obligations are satisfied. Any allegations made are thus limited to the treatment of the complainant, and not the firm's practices in general. Guidelines to this effect would be welcome. As the proposed guidelines expose firms to a wide range of hazards, an appropriate balance regarding protection is required.

8. The lack of analysis in the recommendations given to Recital 40 is also notable, and in particular its interaction with Article 26 of Level II.

9. The inclusion of payments and non-monetary benefits of legal entities between the same group in Recommendation 1 poses immense potential difficulties for such entities, and would potentially leave entities open to similar allegations as articulated in paragraph 4.

10. The diagrams of Annex B are useful in clarifying what constitutes an inducement, however they fail to address the issue of the timing of disclosures of introductory/placement fees to third parties.

11. The Recommendations also fail to illustrate how disclosure is effected in practice, e.g. would such a disclosure be made at the initial presentation (conceivably by the marketing entity of a group) or in the Terms of Business (issued perhaps by the investment entity of the same group)?

12. In paragraph 14, IBF welcomes CESR's provision that "the requirement to enhance the quality of the service to the client is met at the level of the service". However this principle is seemingly contradicted in Example IV, which appears to indicate that tiered/threshold schemes are not compliant with the intended inducements regime. IBF argues that tiered/threshold schemes are proper:

- Tiered schemes often exist because a service is uneconomic and not worthwhile below a certain threshold volume. Ultimately, providers will transfer their losses below the threshold through higher fees. The prohibition of a tiered structure increases the likelihood that such a service will be discontinued
- Top-up revenue from such a dealing service also allows the portfolio manager to maintain a lower portfolio management charge to clients, when considered at the level of the service
- Finally, we disagree with the final statement in example IV that "the incentive scheme is likely to impair the firm's duty to act in the best interests of its clients (for example, to provide best execution)." This statement is valid only when the portfolio manager in the example must choose between two otherwise identical broker services, a situation which is highly unlikely in reality

- Tiered schemes in general offer a means for sharing valuable benefits once initial fixed costs have been recovered and, given consideration at the level of the service, can be highly desirable and wholly proper

13. Paragraph 26 highlights that the examples are only illustrative and cannot be considered outside the specific circumstances of each case. Nonetheless we feel the guidance in example IV (and also VIII) is strongly prejudicial and should be amended. In the interest of balance, paragraph 26 should draw particular attention to the ability to meet the requirements at the level of the service.

### **III. Responses to Questions Posed in CESR's Consultation Paper:**

#### ***Question 1: Do you have any comments on the content of the draft recommendations?***

##### Recommendation 1:

14. The legal basis that CESR refers to in Recommendation 1(a) is unclear: it appears to refer to Article 26 (e). If this is accurate then Recommendation 1 (a) should also acknowledge that Article 26 (e) limits the scope of inducement to “a service provided to a client, in the form of monies, goods or services, other than the standard commission or fee for that service.” We request that CESR issue clarification on this point.

##### Recommendation 2:

15. The reasoning behind the reference CESR to Article 19 (3) of MiFID in the final sentence is unclear. Article 26 of the Level II Directive provides three different situations where the payment of a fee, commission or non-monetary benefit is not considered an inducement. Evidently however, CESR's interpretation of Article 26 (b) is that even if the conditions of Articles 26 (a) and (c) are met, then an investment firm would still be required to meet the requirements of Article 26 (b). IBF requests that CESR explain this interpretation.

##### Recommendation 4

16. Regarding in particular paragraph 17, IBF has reservations as regards the consequences of the factors listed under Recommendation 4 which appear to indicate that CESR is veering towards a strict rules-based implementation of the Directive and away from the preferred principles-based approach.

##### Recommendation 5:

17. IBF welcomes the more flexible interpretation of Recital 39.

#### ***Question 2: Will the examples prove helpful in determining how Article 26 applies in practice? What other examples should be covered or omitted?***

#### ***Question 3: Do you have any comments on the analysis of the examples?***

17. The examples in the consultation paper do add value, however as already articulated, given the widened scope of inducements from the first inducements paper it is still unclear as to when disclosure regarding inducements must be effected, and to what level of granularity on a European-wide basis.

## **ANNEX 1: IBF RESPONSE TO CESR CONSULTATION ON INDUCEMENTS**

**CESR REF: [06-687]**

February 2007

Irish Banking Federation (IBF) is the leading representative body for the banking and financial services sector in Ireland, representing over 60 member institutions, including licensed domestic and foreign banks and institutions operating in the financial marketplace here.

### **General Comments**

1. IBF supports CESR's intention to issue recommendations to its members with the objective of achieving a common approach in relation to the inducements regime.
2. IBF agrees with the management of conflict of interests, namely that firms should assess the services they provide currently in terms of whether conflicts arise in the provision of the service, whether the firm owes a duty to the client, and whether the client's interests are likely to be adversely affected. Firms should continually monitor existing services and also assess new services for potential conflicts of interest. Similarly we agree with the implementation of a fair and reasonable inducements regime also.

### **Specific Comments**

3. Article 26 of Commission Directive 2006/73/EC sets out the conditions that must be met in order for a fee, commission or non-monetary benefit to not be prohibited. The difficulty with this approach is that it starts with the premise that all fees, commissions or non-monetary benefits are harmful which, of course, they are not. An investment firm is entitled to be remunerated on a fair basis for services provided to clients.
4. IBF believes that CESR has taken a far too broad definition of inducements. This problem stems from the absence of any specific definition of the term 'inducements' in either the Level One or Level Two Directives. This poses immense problems for industry and carries the potential to increase costs to both clients and firms.
5. Therefore, in order to assist firms at a practical level, we believe that CESR should have a more restricted interpretation of 'inducements', with a narrower scope. We propose that a payment should only be considered an inducement where it involves a potential source of conflict.
6. IBF takes issue with the appraisal of inducements as "a source of conflict" as a starting point. Equating inducements as intrinsically negative places limits on how much consideration can be given to the context of payments; instead IBF proposes that inducements are defined as "a potential source of conflict" at a minimum.
7. We suggest that there is considerable room for CESR to manoeuvre and adopt carve-outs that would benefit industry while not impinging upon consumer protection. One such carve-out that would be beneficial would be to distinguish between 'remuneration' and 'inducements'. The CP does not appear to acknowledge at any point that the firm is entitled to remuneration for the services which it provides.

8. Some of the examples set out in paragraph 25, (3 and 6) seem to suggest that any volume-based or tiered incentive scheme would be illegal (whether accepted or paid by a firm). Example 7 suggests that providing any mechanism that makes it easier for an investment firm to do business with you (e.g. access to a computer system) could be illegal. Paragraph 42 suggests that it will be very difficult to create any softened or bundled arrangement that constitutes a "proper fee" as it won't relate to any particular client.

9. When firms establish working arrangements with each other, these can lead to improved efficiency, the benefits of which should be passed on to clients. The details of these arrangements will differ between firms, as each has different internal arrangements, and the most efficient interface with other client firms will also differ.

10. The effect of the CESR approach may be to make almost any arrangement promoting an effective working relationship between firms non-compliant.

- If the arrangement includes any recognition of the improved efficiency, it fails to meet this interpretation of inducements obligations
- If the arrangement does not reflect the improved efficiency, best execution obligations may not be met

It is also arguable that, should firms decide on this basis that they will not explore such arrangements, they also fail to meet their obligations for monitoring execution.

11. Firms should be encouraged to find efficient ways to work together and pass appropriate benefits on to clients. The approach proposed places significant obstacles in the way of such actions.

12. In our opinion, improper inducements are more likely to arise from abuse of proper inducement structures, rather than from the structures themselves. More useful guidelines would focus on how firms can decide that inducements do not create an inappropriate conflict of interest, whether they are recipients or providers of the incentive.

13. IBF believes that the concept of "proportionality" articulated in Recital 32 merits consideration beyond the context of investment research. Small gifts or minor hospitality below a specified level that are specified in the firm's conflict of interest policy and its summary description should not be considered inducements.

14. IBF also contends that reflection on inducements is intrinsically linked to the broader area of conflicts of interest. We note that CESR intends issuing papers on elements of conflicts of interest next year.

- The appointment and monitoring of tied agents- not due **until** Q4 2007/Q1 2008.
- Conflicts of interest policy- due **after** Q2 2008.

However, the gap between these papers and this consultation further complicates consideration of the issues.

15. In Example 2, the point that "CESR's view is that it is not the intention of MiFID ***altogether*** to prohibit such arrangements" (italics, bold added) implies that MiFID's purpose is to curtail such arrangements which is contrary to the underlying logic of MiFID, i.e. that limiting the development of distribution models militates against market completeness, which is a crucial aspect of market integration.

16. Regarding the issue of softing and bundling, IBF would advocate a common approach from European Regulators but given its complexity and dynamic nature, industry would

propose significant consultation between industry and regulator, be it at the national or European level.

## **17. Responses to Questions Posed in CESR's Consultation Paper:**

***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?***

A literal interpretation of Article 26 implies that all fees, commissions and non-monetary benefits are caught. However, we do not believe such an approach to be a sensible one. Given the lack of clarity in the definition of inducements at Levels 1 and 2, we believe that CESR should adopt a more pragmatic and sensible interpretation that would result in a narrower definition. We do not believe that standard fees and commissions charged by an investment firm should be considered as inducements. These fees and commissions must be disclosed to clients in accordance with Article 33 of Directive 2006/72/EC and that, in itself, offers protection to the client.

In considering whether or not a fee is an inducement, the important issue is whether this involves a potential conflict of interest. If this is the case, can appropriate safeguards be put in place, including disclosure to the client? If yes, then the fee should not be prohibited.

***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?***

Again, we believe CESR's definition of inducements is too wide and that a more pragmatic approach is merited.

***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 set out in CESR's example on page 6, we believe that where the client has given explicit instructions to a third party to pay charges on its behalf, the payment should fall under Article 26(a) and, therefore, should not be considered an inducement.

***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"?***

See answer to question 3 above.

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

IBF believes that the examples listed are not extensive, particularly given the dynamic and innovative nature of the industry and that the conclusions drawn may mitigate against other principles enshrined in MiFID, including best execution.

The approach being adopted by CESR seems to prohibit all situations where there could be a 'lesser' incentive for the investment firm to act in the best interests of the client. No recognition is given to an investment firm's ability to manage conflicts of interest.

Example 4: It will not always be feasible for relevant training to be provided in the investment firm's premises. It should be possible to hold this training at another practical non-exotic location.



***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?***

The factors seem logical but we repeat our comment above in relation to a firm's ability to manage its conflicts of interest.

***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 that it would not be useful to develop further guidance beyond such a statement. It would not be pragmatic to develop guidance to cover all situations.

***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 concur with CESR's conclusion that Article 26 applies to the intermediary with the direct relationship with the client.

***Question 12: Would it be helpful for there to be a common supervisory approach across the EU to softing and bundling arrangements?***

IBF would advocate a common approach, but preferably developed by industry.

***Question 13: Would it be helpful for CESR to develop that common approach?***

IBF believes that an industry-driven approach would be most pragmatic.