

EuroFinuse's Response to the ESMA Consultation Paper on Guidelines on remuneration policies and practices (MiFID)

Reply of the European Federation of Financial Services Users (EuroFinuse)

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Executive summary

EuroFinuse welcomes this Consultation on the Guidelines on remuneration policies and practices in the context of MiFID rules on conflicts of interest and conduct of business drafted by ESMA; and after having received feedback from EU Member States through the Questionnaire to supervisors of investment firms from July 2011. We understand it is necessary to open up the debate to relevant stakeholders and to gather all available information. We would like to refer to the late and sometimes deficient transposition of the requirements for remuneration in the financial services industry as set up by the Capital Requirements Directive III. Several EU Member States (Greece, Italy, Portugal, Poland, Slovenia and Spain) were warned in May 2011 (that is to say, several months after the deadline for transposition of the CRD III by 1st January 2011) as they had not yet implemented any of the provisions of the Directive, in addition to Slovakia, that had not implemented the provisions related to staff¹ remuneration¹.

We believe that remuneration policies under MiFID should not be treated as a minor issue. The ESMA guidelines should not only aim at improving current practices but also at avoiding the possibility that certain remuneration practices cause systemic risk as well as conflicts with the primary duty of investment firms i.e. to act in the best interest of their clients. Therefore, establishing recommendations or mere guidelines lacking legal “teeth” should not be the answer to be considered at EU level. As long as there are no clearly defined red lines for managers’ conduct (when determining their salaries and the remuneration policies for the rest of the staff) any possible liabilities will be open to individual opinion and judgement, which will continue to encourage unacceptable behaviour.

Within the mandate ESMA should consider giving national regulators guidance on how to enforce these regulations if they discover skewed incentive schemes at firms or financial institutions.

¹ http://europa.eu/rapid/press-release_IP-11-612_en.htm

Q1 Do you agree that firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties and conduct of business risk management obligations so as not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests, to the potential detriment of clients? Please also state the reasons for your answer.

Yes, we believe that indeed conflicts of interest are the most common source of risk in the financial services' industry. Therefore, all firms must draft a document establishing the foreseen mitigation measures to address any internal or external conflicts of interest that may exist in relation with the firm's activity. This document will have to be sent to and validated by the competent national authority of the EU MS under which the firm is established. ESMA should establish that if a conflict of interest occurs and the firm or financial institution does not have any internal regulation on how to deal with such a conflict, the management has to end the relationship at which gave rise to the conflict.

Q2 Do you agree that, when designing remuneration policies and practices, firms should take into account factors such as the role performed by relevant persons, the type of products offered, and the methods of distribution? Please also state the reasons for your answer.

In order to answer this question, we would like to refer to the example of Spanish financial institutions (banks and savings banks or *Cajas de Ahorros*). They had to solve within a short period of time their structural solvency problems - aggravated after the adoption of the Capital Requirements Directive IV- in a time of economic depression and uneasy capital markets access. The management decided that the easiest and fastest way to do so was through the massive commercialisation of preference shares, i.e. high returns equity that was sold to retail investors for which, according to their profile risk, these financial products were unsuitable². Banks and *Cajas* used their commercial networks and sold such equity to lifelong clients through their branches. Very commonly clients were advised to invest all their savings in these products, even ignoring basic portfolio diversification investment principles³.

² To a certain extent, we consider that the higher capital base requirements after the adoption of Basel III principles through CRD IV not only forced EU financial institutions to reduce credit to the real economy but also indirectly pushed financial institutions to sell financial instruments according to their eligibility for capital requirements more than to the clients' needs, due to the absence of measures preventing advice biases by enforcing the fair exact and not misleading information, suitability and "inducements" provisions of MiFID.

³ "The Scandal of Preference Shares", Cinco Dias, June 4th 2012

http://www.cinco dias.com/articulo/opinion/escandalo-preferentes/20120704cdscdiopi_6/

"Investors in Spanish banks share the pain", Wall Street Journal, August 24th 2012

<http://online.wsj.com/article/SB10000872396390444358404577607360550858958.html>

Therefore, normative changes are another reason why the management may adopt short-termist remuneration practices, in addition to other pressure methods⁴ that contribute to biased financial advice provision.

Moreover, it is necessary that when designing remuneration policies and practices firms also take the timeframe of the investment product into account. Indeed, remuneration should be deferred and be aligned with the investment horizon in order to avoid short-termism and excessive risk taking.

Q3 Do you agree that when designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced?

Indeed, remuneration policies should look carefully at the fixed and variable component of total remunerations. We understand that it is equally necessary to pay attention to the relationship between the fixed and variable components of the salary for managers and for those involved with the direct commercialisation of products to clients: fixed and variable components impact differently regarding systemic risk and appropriateness of financial advice to clients. In this sense, we would like to refer to the current work of the European Parliament on the proposal for the UCITS V Directive and the previous dispositions as established through the AIFMD. Furthermore, we think that the variable component should always be related to the fixed component whereas the variable component at maximum is 200% of the fixed component (e.g., variable remuneration maximum 2/3 of total remuneration).

Q4 Do you agree that the ratio between the fixed and variable components of remuneration should therefore be appropriate in order to take into account the interests of the clients of the firm? Please also state the reasons for your answer.

Yes, indeed the ratio between fixed and variable remuneration components has a clear impact on the financial advice offered to clients. Certain ratios or thresholds should be established similarly to the UCITS V Directive proposal.

⁴ According to the Commission for Investigation created by the Regional Parliament of Valencia upon the failure of the regional savings bank CAM (Caja de Ahorros del Mediterraneo). Mr Hernández Olivares, member of CAM's Commission for Control, declared to the Commission that branch directos had to comply with the quantitative objectives established by the management and, if such objectives were not reached, had to provide explanations to the management.

Source: Bellod Redondo, J.F.: "Fraud and Financial Engineering: The Case of Caja de Ahorros del Mediterraneo" Contribuciones a la Economía Magazine, August 2012
<http://www.eumed.net/ce/2012/jfbr5.html>

Q5 Do you agree that the performance of relevant persons should take account of non-financial (such as compliance with regulation and internal rules, market conduct standards, fair treatment of clients etc.), as well as financial, criteria? Please also state the reasons for your answer.

Yes, indeed performance should also be quantified according to non-numerical variables. However, we would like to point out that compliance to regulation and internal rules, market conduct standards and fair treatment of clients should not in any case be the only variables to consider when determining the salary. They are requirements to meet and, in case of non-compliance by the member of the staff, should imply penalisation either internally, from supervisors or the relevant authority.

Q6 Do you agree that the design of remuneration policies and practices should be approved by senior management or, where appropriate, the supervisory function after taking advice from the compliance function? Please also state the reasons for your answer.

Remuneration policies should be first established by the management and if relevant, approved by shareholders in general assembly meetings. Relevant authorities (now national supervisors and the European Banking Authority after the settlement of the Banking Union) should be notified of such remuneration policies and intervene where appropriate. Senior management must verify that such remuneration policies are compliant with EU rules, especially with MiFID implementation Directive article 26 on “inducements”. In other words, any investment firm employee providing “advice” to individual citizens cannot be compensated, directly or indirectly, through product sales commissions.

Q7 Do you agree that senior management should be responsible for the implementation of remuneration policies and practices, and for preventing and dealing with any the risks that remuneration policies and practices can create? Please also state the reasons for your answer.

Indeed, senior management is the most appropriate level to establish remuneration guidelines for the entire firm. They should, especially in the case of the management, be duly disclosed and confirmed by shareholders in general assembly meetings. They should also be liable for establishing remuneration policies that do not address conflicts of interest, contribute to systemic risk and may threat the provision of financial advice according to the best interest of the client (according to the MiFID definition).

Q8 Do you agree that the organisational measures adopted for the launch of new products or services should take into account the remuneration policies and practices and the risks that the new products or services may pose? Please also state the reasons for your answer.

We agree with the fact that especially in the case of new products it is especially important to take the remuneration policies especially for the sales staff into account.

Q9 Do you agree that the process for assessing whether the remuneration features related to the distribution of new products or services comply with the firm's remuneration policies and practices should be appropriately documented by firms? Please also state the reasons for your answer.

These remuneration features should be auditable by national and European supervisors. Therefore, they need to be documented.

Q10 Do you agree that firms should make use of management information to identify where potential conduct of business and conflict of interest risks might be occurring as a result of specific features in the remuneration policies and practices, and take corrective action as appropriate? Please also state the reasons for your answer.

It is of great concern that this is not yet the case within firms or financial institutions. It is a principle of management information systems that as a result the management is informed and can act on conduct of business of conflicts of interest. Especially, when lack of these procedures will lead to less suitable advice for retail investors or financial consumers.

Q11 Do you agree that firms should set up controls on the implementation of their remuneration policies and practices to ensure compliance with the MiFID conflicts of interest and conduct of business requirements, and that these controls should include assessing the quality of the service provided to the client? Please also state the reasons for your answer.

In principle yes, but given the various size of investment firms, there should be first a cost impact assessment of such a requirement. The key is that supervisors could and indeed sometimes investigate the enforcement of MiFID provisions on remuneration features for "sales" and "advice" employees.

Q12 Do you agree that the compliance function should be involved in the design process of remuneration policies and practices before they are applied to relevant staff? Please also state the reasons for your answer.

Same reply as to Q 11.

Q13 Do you agree that it is difficult for a firm, in the situations illustrated above in Annex I, to demonstrate compliance with the relevant MiFID rules?

Q14 If you think some of these features may be compatible with MiFID rules, please describe for each of (a), (b), (c) and (d) in Annex I above which specific requirements (i.e. stronger controls, etc.) they should be subject to.