Consultation paper

Guidelines on remuneration policies and practices (MiFID)

September 2012 | ESMA/2012/570

European Securities and Markets Authority

Date: 17 September 2012
ESMA/2012/570

Responding to this consultation paper

ESMA invites comments on all matters set out in this consultation paper and, in particular, on the specific questions listed in Annex II. Comments are most helpful if they:

- indicate the number of the question to which the comment relates;
- respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by 7 December 2012.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input/Consultations'.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper?

This consultation paper should be read by investment firms (as defined in Article 4(1) (1) of MiFID), credit institutions, UCITS management companies and external Alternative Investment Fund Managers (AIFMs) that provide investment services[1], competent authorities, trade bodies and consumer groups. Although this consultation paper principally addresses situations where services are provided to retail clients, its content should also be considered as applicable, to the extent it is relevant, when services are provided to other clients.

[1] These guidelines only apply to UCITS management companies and external AIFMs when they are providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD).

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Acronyms

AIFMD	Alternative Investment Fund Managers Directive
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CRD	Capital Requirements Directive
EBA	European Banking Authority
EEA	European Economic Area
ESMA	European Securities and Markets Authority
MiFID	Markets in Financial Instruments Directive
UCITS	Undertakings for Collective Investment in Transferable Securities

I. Overview

Reasons for publication

1. In its response to CEBS dated 23 November 2010[2], CESR noted that the draft CEBS 'Guidelines on remuneration policies and practices' (CP42) focused mainly on the remuneration policies and practices in the financial sector from a prudential perspective (although, as the CEBS guidelines highlighted, the Capital Requirements Directive (CRD) requires that remuneration policies and practices incorporate "measures to avoid conflicts of interest")[3], and that it would be appropriate for CESR to develop a complementary set of guidelines focused on remuneration from an investor protection perspective.[4] Firms should make sure that their remuneration policies and practices take into account not only, for example, conflicts of interest of a prudential nature, but also conflicts of interest - as understood under MiFID - that arise in the provision of services to their clients, as well as MiFID's conduct of business requirements.

2. In particular, CESR noted that the remuneration policies and practices of investment firms and credit institutions should be designed and maintained in the context of investor protection when providing investment services under the Markets in Financial Instruments Directive (MiFID[5]).[6]

3. Articles 13(3) and 18 of MiFID and Articles 21, 22 and 23 of the MiFID Implementing Directive[7] set out the obligations on firms in respect of conflicts of interest. Article 19 of MiFID sets out the conduct of business obligations of firms when providing investment and/or ancillary services. These conduct of business obligations include the overarching obligation on firms to act honestly, fairly and professionally in accordance with the best interests of its clients. Remuneration policies and practices that are not compatible with these requirements are not compliant with MiFID, and supervisors need to intervene when carrying out their supervisory duties.[8]

4. In the European Commission's consultation paper on the MiFID review[9], it states that:

   "*Conflicts of interest requirements … includes the remuneration of sales forces and the structure of incentives for the distribution of financial products. The Commission services consider that the framework for addressing conflicts of interest within MiFID is still appropriate to prevent failures in the sales process provided that it is consistently applied across Europe. The key element of this framework is the management and the avoidance of conflicts – not just disclosure. While the framework also addresses circumstances in which the disclosure of conflicts of interest might be necessary, this is a measure of last resort and not a means for managing conflicts of interest. For instance, it would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts*

[2] Ref: CESR/10-1412.
[3] The remuneration policy requirements are defined in Article 22 and Annex V, 11, points 23 and 24 of CRD III.
[4] Due to their scope (prudential approach) and legal basis (CRD), CESR noted that the CEBS guidelines were not the right place to include this specific investor protection dimension.
[5] Directive 2004/39/EC.
[6] This was previously underlined by CESR in, for example, its report on 'Inducements: good and poor practices', 19 April 2010, Ref. CESR/10-295; as well as in its 'Responses to questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID', 29 July 2010, Ref. CESR/10-860 - see point 4, on page 4 'Specific organisational requirements related to the launch of new services or products'.
[7] Which implement Articles 13(3) and 18 of MiFID.
[8] Article 50 of Directive 2004/39/EC.
[9] "Review of the Markets in Financial Instruments Directive (MiFID)", European Commission, 8 December 2010, page 70.

of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID."

5. Evidence gathered from ESMA's July 2011 remuneration questionnaire to supervisors[10] indicated the divergent ways in which firms determine how to address conflicts of interest and conduct of business risks arising from their remuneration policies and practices. ESMA believes that this divergence in approaches to the setting of remuneration for relevant persons could be addressed, in part, by appropriate guidelines based on current MiFID requirements (and, in future, as revised to support the consistent implementation of MiFID 2).

6. This paper, in accordance with Article 16(2) of the ESMA Regulation[11], sets out for consultation draft ESMA guidelines on remuneration policies and practices in the context of MiFID rules on conflicts of interest and conduct of business.

7. These draft guidelines aim to foster a consistent application and improved implementation, of the existing MiFID conflicts of interest and conduct of business requirements in the area of remuneration across the EEA Member States. In turn, this should strengthen investor protection – a key objective for ESMA.

8. The focus of these guidelines is the remuneration of all persons involved in the provision of investment and/or ancillary services; in particular, those who can have a material impact on the service provided and on the conduct of business risk[12] profile and/or who can influence corporate behaviour (referred throughout the text as 'relevant persons'). Relevant persons may be client-facing front-line staff, sales force staff, and/or other staff indirectly involved in the provision of investment services whose remuneration may create inappropriate incentives to act against the best interests of their clients. These also include relevant persons that oversee the sales force (such as line managers) who may be incentivised to put pressure on the sales staff, or financial analysts[13] whose literature may be used by sales staff to induce clients to make investment decisions. In addition, relevant persons involved in complaints handling, claims processing, client retention and in product design and development are other examples of relevant persons who can have material impact on the service provided and/or corporate behaviour.

9. These guidelines are mainly targeted at sales activities with retail clients, as indications from competent authorities are that this is a high-risk area. Nonetheless, they should also be considered as applicable, to the extent they are relevant, when services are provided to any type of clients (MiFID Articles 13 and 18 apply irrespective of the status of the clients).

10. For the purposes of these guidelines, remuneration consists of all forms of payments or benefits provided directly or indirectly by firms to relevant persons in the provision of investment and/or ancillary services to clients. Furthermore, where entities or persons provide services to firms on the basis of an outsourcing arrangement or as tied agents, the remuneration provided by firms to the out-

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[10] See Annex IV.

[11] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

[12] By 'conduct of business risks' we mean the risk that when engaging in activities with or providing services to clients, the behaviour of firms will result or have the potential to result in firms not acting honestly, fairly, and professionally leading to poor outcomes for/detriment to their clients.

[13] Financial analysts are also subject to the Investment Research rules (Art 24 of MiFID Implementing Directive).

sourced entity or person or tied agent is also regarded as remuneration for the purposes of these guidelines. In such cases, firms should also ensure that the tied agents and outsourced entities have remuneration policies and practices that are equally as effective as the firms' own arrangements in addressing and mitigating the potential conduct of business and conflict of interest risks.

11. Remuneration can be divided into either fixed remuneration (payments or benefits without consideration of any performance criteria) or variable remuneration (additional payments or benefits linked to performance or, in certain cases, other contractual criteria). Both components of remuneration (fixed and variable) may include monetary payments or benefits (such as cash, shares, options, cancellations of loans to relevant persons at dismissal, pension contributions, remuneration by third parties e.g. through carried interest models, wage increases) or non-monetary benefits (such as health insurance, discounts, or special allowances for car or mobile phone etc).

12. Firms should ensure that remuneration is not paid in a manner that aims at circumventing the MiFID requirements and/or these guidelines. Senior management[14] or, where appropriate, the supervisory function of each firm has the primary responsibility for ensuring that the ultimate goal of having appropriate remuneration policies and practices is not circumvented both at individual or group-wide level. A balance between the requirement of the parent undertaking to have the group remuneration policy applied coherently and the requirement of subsidiaries to take into account local responsibilities, based on the local risk profile and regulatory environment, should be achieved.[15] Competent authorities should also devote adequate attention to this issue.

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13. Section II explains the background to the proposed guidelines in more detail.

14. Section III sets out the rationale for the draft guidelines on governance and design of remuneration policies and practices in the context of the MiFID conduct of business and conflicts of interest requirements.

15. Section IV sets out the rationale for draft guidelines on controlling risks that remuneration policies and practices create.

16. Annex I sets out illustrative examples of remuneration policies and practices that create conflicts that may be difficult to manage; Annex II lists all the questions set out in the consultation paper; Annex III sets out the cost-benefit analysis; Annex IV contains a copy of ESMA's remuneration questionnaire to supervisors; Annex V contains the full text of the draft guidelines.

Next steps

17. ESMA will consider the responses it receives to this consultation paper in Q1 2013 and expects to publish a final report, and final guidelines, by Q2 2013.

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14 ESMA recognises that different governance structures are used across Member States (for example, unitary or a dual board structure). These draft guidelines are based on the current MiFID text. We have therefore continued to use the current MiFID term "senior management" in this CP (which is also consistent with terminology used in the ESMA 'Guidelines on certain aspects of the compliance function' – see ESMA/2012/388).

15 Circumstances and situations that may pose a greater risk to this may be: the use of off-shore centres; the setting up of structures or methods through which remuneration is paid in the form of dividends or similar pay-outs (e.g. improper use of carried interest models); and material non-monetary benefits awarded as incentive mechanisms linked to performance.

18. These guidelines are based solely on the current MiFID requirements. The potential impact of the MiFID review proposals falls outside of the scope of this exercise. However, ESMA will consider whether these guidelines will need to be revised on MiFID 2 implementation.

II. Background

19. In preparation for developing a set of guidelines to complement the CEBS guidelines, in July 2011 ESMA launched a questionnaire to supervisors of investment firms and credit institutions on "remuneration of staff involved in the provision of investment services: compliance with the conduct of business and conflicts of interest rules".

20. The intention was for ESMA to better understand the nature and the scale of the issues caused by remuneration policies and practices in the context of the MiFID conduct of business and conflicts of interest requirements. These MiFID requirements are:

    a. Article 19 of MiFID ('conduct of business obligations when providing investment services to clients') which includes obligations on Member States to require investment firms and credit institutions, when providing investment services and/or ancillary services, to act honestly, fairly and professionally in accordance with the best interests of its clients.

    b. Articles 13(3) and 18 of MiFID, and Articles 21, 22 and 23 of the MiFID Implementing Directive, which oblige Member States to require investment firms and credit institutions:

        i. to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from adversely affecting the interests of their clients;

        ii. to establish and maintain an effective policy which sets out the procedures and measures to identify and manage conflicts of interests between themselves (i.e. the firms), including their managers, employees and tied agents or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment or ancillary services, or combinations thereof;

        iii. to clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on their behalf - where organisational or administrative arrangements established by firms are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented (see also paragraphs 31 and 32).

21. The aim of the ESMA questionnaire was (i) to gather information from different Member States on remuneration practices of investment firms and credit institutions in relation to conduct of business risks and conflicts of interest risks[16], when providing investment services; and (ii) to collect information about the way supervisors in different Member States assess and challenge those remuneration practices in light of these risks.

22. The questionnaire focused on the risks that remuneration policies and practices and other incentives in relation to relevant persons could result in detriment for clients (i.e. situations where remuneration incentives that stem from the firm's remuneration policies and practices may encourage detri-

[16] By "conflicts of interest risk" we mean the risk of conflicts that may arise between the interests of the firm and the interests of its clients as a result of the firm's remuneration policies and practices.

ment to the interests of the client). The conclusions drawn from the responses fall into three main categories as follows:

a. Understanding of the relevant MiFID organisational and conduct of business requirements: Member State responses indicated that it would be useful to set out clearly and comprehensively the MiFID organisational and conduct of business requirements firms should comply with when setting and operating remuneration policies and practices;

b. Governance requirements: Responses indicated that some firms fall short when it comes to the governance of their remuneration policies and practices – failing to recognise their responsibilities to consider, for example, whether targets and incentives create particular risks that need to be mitigated;

c. Identification of practices that create conduct of business and conflicts of interest risks that may be difficult to manage: Member State responses highlighted several high-risk remuneration policies and practices. These sorts of risks may be difficult for firms to manage successfully.

Other relevant initiatives

23. In developing these guidelines, ESMA has considered a number of other relevant remuneration initiatives, specifically the work being done to develop guidelines on remuneration under the Alternative Investment Fund Managers Directive (AIFMD)[17], for which ESMA published a consultation paper (ESMA/2012/406) on 28 June 2012[18], and has also given regard to the CRD remuneration requirements.

24. In this context, ESMA notes that once AIFMD and the future UCITS V directive[19] are in place, the regulation of the European asset management industry will fall under three directives: UCITS managers under UCITS, other fund managers under AIFMD, and portfolio managers under MiFID/CRD.[20]

25. The revised CRD introduced remuneration requirements for credit institutions as defined under Article 4(1) of Directive 2006/48/EC and investment firms as defined under Directive 2006/49/EC, which in turn refers to MiFID (Article 4 (1)(1)). This means that such firms are required, according to the CRD, to have remuneration policies and practices that are consistent with and promote sound and effective risk management. ESMA considers that the principles of CRD should be read across to MiFID in order to address conduct of business risks in a consistent manner (for example, CRD principle (b) of Annex V point 23 states that the remuneration policies and practices should be in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporate measures to avoid conflicts of interest).

[17] Directive 2011/61/EU.
[18] http://www.esma.europa.eu/system/files/2012-406.pdf.
[19] On 3 July 2012 the Commission adopted a proposal for a directive amending Directive 2009/65/EC as regards depositary functions, remuneration policies and sanctions. The proposal is available at: http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-proposal_en.pdf.
[20] The interaction between the AIFMD and UCITS rules on remuneration is still to be determined, but a UCITS management company or an AIFM providing MiFID services would be required to comply also with the MiFID remuneration rules under Article 6(4) of the UCITS Directive and Article 6(6) of the AIFMD.

26. Firms should make sure that their remuneration policies and practices take into account not only, for example, conflicts of interest of a prudential nature, but also conflicts of interest - as understood under MiFID - that arise in the provision of services to their clients, as well as MiFID's conduct of business requirements.

General

27. Improper incentives in remuneration policies and practices are widely regarded as one of the causes of the financial crisis. This is particularly true for incentives that encourage firms to take unwanted and irresponsible risks because the incentives promote a bias in favour of short-term profitability and immediate benefits for relevant persons. These remuneration policies and practices can also cause firms to neglect the client's best interest, and to focus instead on short-term profit realisation. Firms should therefore design and monitor their remuneration policies and practices in order to prevent improper incentives in the remuneration of all stakeholders within the firm and, in particular, in the context of the MiFID conduct of business and conflicts of interest requirements.

28. These guidelines attempt to address high-level remuneration policies and practices in firms as well as the day-to-day practices that result from remuneration decisions and procedures through which remuneration policies and practices are implemented from an investor protection perspective. They do not aim to set out what constitutes an effective remuneration arrangement.

29. These guidelines do not cover inducements under Article 26 of the MiFID Implementing Directive. However, one should keep in mind that both remuneration and inducements may give rise to the same types of client protection issues.

30. By issuing these guidelines, ESMA wishes to ensure that all types of incentives (i.e. not only payments between firms – inducements, but also payments within a firm - remuneration) are taken into account. The aim of these guidelines is therefore not to duplicate the provisions that already exist for inducements, but to emphasise the regulatory framework of remuneration practices by focussing on payments within a firm. More clarity about the conflicts of interests which remuneration policies and practices can create will also help the understanding of the inducements rules, in particular under Article 26(b)(ii) of MiFID Implementing Directive.

31. These guidelines do not cover disclosure requirements as foreseen in Article 18(2) of MiFID, as disclosure is not an effective self-standing measure to manage conflicts of interest in relation to remuneration, and should only be used by firms as a measure of last resort. In particular, in circumstances where the firm's procedures and measures are not sufficient to ensure that the risk of detriment to the client's interest is prevented, firms should first consider whether any other reasonable measures could be taken that would effectively reduce the potential damage to the client's interest.[21]

32. Nevertheless, ESMA notes that Article 18(2) of MiFID provides that disclosure is required where organisational or administrative policies and practices established by the firm in accordance with Article 13(3) to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented. However, while disclosure of specific con-

[21] Such measures could include firms taking steps to avoid any conflicts of interest, for example those conflicts that may reasonably be foreseen when designing internal remuneration policies and practices.

flicts of interest is required by Article 18(2), over-reliance on disclosure without adequate consideration as to how a conflict may appropriately be managed is not permitted.[22]

33. The guidelines contain examples of good and poor practices, and Annex I sets out illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which therefore it would be very difficult for a firm to demonstrate compliance with MiFID requirements. These descriptions aim to clarify the application of current rules, but do not create additional requirements for firms or competent authorities.

34. When referring to organisational requirements, these guidelines should be read together with the proportionality principle as set out in Article 22 of the MiFID Implementing Directive. This will give firms the necessary flexibility to comply with the guidelines according to the nature, scale and complexity of their business. For example, the guidelines on controls are applicable to small firms as we expect them to have appropriate and proportionate controls.

[22] See recital 27 of MiFID Implementing Directive.

III. Governance and design of remuneration policies and practices in the context of the MiFID conduct of business and conflicts of interest requirements

Overview

35. A key objective in delivering effective implementation of MiFID conduct of business and conflicts of interest requirements is the identification, prevention, management, and control of potential conduct of business and conflict of interest risks. Robust governance arrangements and controls around the design, approval and management of remuneration policies and practices are essential to ensuring that the clients' interests are protected.

36. Central to this is an understanding of the role that senior management or, where appropriate, the supervisory function plays in setting and maintaining the firm's culture. The culture of the firm facilitates behaviours across the firm which lead to judgements that impact client outcomes. The culture of the firm influences the manner in which the risks are managed. Where senior management or, where appropriate, the supervisory function is focused on short-term profitability only, it is likely that the obligation on firms to act in the best interests of their clients is inadequately upheld.

37. Remuneration policies and practices should reflect the firm's obligations regarding fair treatment of its clients and promote appropriate corporate behaviours by relevant persons.

38. Supervisory experience suggests that some firms fall short of the requirements when it comes to setting a governance framework around the design and approval of their remuneration policies and practices. For example, firms fail to consider whether their internal sales targets and incentives create actual or potential risks that may cause damage to their clients' interests, and whether they need to be managed.

39. Supervisory experience also indicates that the design of some remuneration policies and practices does not place emphasis on the duty to act honestly, fairly, professionally and in the best interests of clients. For example, encouraging bias towards products that are easier, quicker or more profitable to sell, but which may not be suitable for the clients' needs, is likely to fall foul of MiFID's requirements.

40. MiFID's organisational requirements (Article 13(2)) oblige investment firms to establish policies and procedures sufficient to ensure compliance of the firm and its relevant persons with its obligations under MiFID (including its obligations regarding conflicts of interest). The governance arrangements for remuneration fall under this requirement.

41. The aim of this section is to clarify the role of senior management or, where appropriate, the supervisory function (and the governance framework) when designing, implementing and maintaining remuneration policies and practices.

Guidelines

42. When designing or reviewing remuneration policies and practices, firms should consider the conduct of business and conflicts of interest risks that may arise. A firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties (to include avoiding conflicts of interests deliberately created by the policies and practices) and conduct of business

risk management obligations, in order to ensure that clients' interests are not impaired by the remunerations policies and practices adopted by the firm in the short, medium and long term.

43. Remuneration policies and practices should be designed in such a way 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.

Question

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.

44. In the design of the remuneration policies and practices, firms should consider all relevant factors such as the role performed by relevant persons, the type of products offered, and the methods of distribution (e.g. advised or non-advised, face-to-face or through telecommunications) in order to prevent potential conduct of business and conflict of interest risks from adversely affecting the interests of their clients and to ensure that the firm adequately manages any related residual risk.

Question

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.

45. When designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced. Furthermore, the remuneration mechanisms in place should allow the operation of a flexible policy on variable remuneration, including, where appropriate, the possibility to pay no variable remuneration at all.

46. High variable remuneration can increase the relevant person's focus on short-term gains rather than the client's best interest. The ratio between the fixed and variable components of the remuneration received should therefore be appropriate in order to take into account the interests of all stakeholders (including firms' clients).

Questions

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?

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.

47. Where remuneration is, in part, variable, firms' remuneration policies and practices should define appropriate criteria to be used to assess the performance of relevant persons. Such assessment should be based on both financial (quantitative) and non-financial (qualitative) criteria encouraging

the relevant persons to act in the best interests of the client.[23] Examples of non-financial (qualitative) criteria include compliance with regulatory requirements and internal procedures, market conduct standards, fair treatment of clients and business retention.

48. Furthermore, where a firm's policy provides for variable remuneration, the firm should adopt and maintain measures enabling it to promptly identify where the relevant person fails to act in the best interests of the client and to take remedial action.

49. In determining the performance of relevant persons firms should also take into account the outcome of their activities in terms of compliance with the conduct of business rules and, in general, with the duty to care about the best interests of their clients.

Question

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.

50. 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, and implemented by appropriate functions to promote effective corporate governance. There should be effective oversight in place within the firm to approve the remuneration policies and practices. Senior management should be responsible for the implementation of remuneration policies and practices and for preventing and dealing with any risks that remuneration policies and practices can create.[24]

Questions

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.

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.

51. Relevant persons should be clearly informed at the outset of the criteria that will be used to determine the amount of their remuneration and the steps and timing of their performance reviews. The criteria used by firms to assess the performance of relevant persons should be accessible, understandable and recorded.

52. Firms should avoid creating unnecessarily complex policies and practices (such as combinations of different policies and practices, or multi-faceted schemes, which increase the risk that relevant per-

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[23] In line with CRD III principle G that states *'where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individuals performance, financial as well as non- financial criteria are taken into account'.*

[24] In line with CRD III principle C that states *'the management body in its supervisory function of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation'.*

sons' behaviour will not be driven in the way firms intend, and that any controls in place will not be as effective to identify the risk of detriment to the client). This may potentially lead to inconsistent approaches and hamper proper knowledge or control of the policies by the compliance function. Annex I of the draft guidelines sets out illustrative examples of remuneration policies and practices that create risks that may be very difficult to manage due to their complexity and strong incentives to sell specific products.

53. Firms should have written remuneration policies which should be periodically reviewed.

54. Examples of good practice:

- The variable part of the remuneration paid out is calculated and awarded on a linear basis rather than being dependent on meeting an 'all or nothing' target. In some cases, the firm decides to pay out the variable remuneration in several tranches over an appropriate time period, in order to adjust for and take into account the long term results.

- A firm has fundamentally changed the ratio between fixed and variable income. The variable component of the remuneration has been considerably reduced and the fixed part of the income has been increased. The new ratio more closely reflects the desired conduct of the employees to act in the best interests of clients.

- When offering additional incentive payments for reaching required levels of sales, a firm takes into account whether the relevant person meets the firm's quality standards or standards of compliance - such as, rates of business retention (or lapses); whether it upholds any complaints about advice etc.

- References used in the calculation of variable remuneration of staff are common across products sold and include qualitative criteria.

55. Examples of poor practice:

- A firm has started offering advisers specific additional remuneration to encourage clients to apply for new fund products in which the firm has a specific interest. This often involves the relevant person having to suggest that their clients sell products that they would otherwise recommend they retain so they can invest in these new products.

- A firm sells investment products with an inappropriate balance of risk and reward for the clients in question. Warnings of the risk manager are ignored because the investment products generate high returns for the firm. Managers and employees therefore receive a large bonus. When the risks that had been identified occur, the bonuses have already been paid out.

Explanatory text

56. Where firms' remuneration policies and practices link remuneration directly to the sale of specific financial instruments or of a specific category of financial instrument, it is unlikely that such firms could, in this situation, demonstrate compliance with MiFID.

57. Firms should ensure that the organisational measures they adopt regarding the launch of new products or services appropriately take into account their remuneration policies and practices and the risks that these products or services may pose. In particular, before launching a new product, firms

should assess whether the remuneration features related to the distribution of that product comply with the firm's remuneration policies and practices and therefore do not pose conduct of business and conflicts of interest risks. This process should be appropriately documented by firms.

Questions

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.

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.

58. When firms' policies allow for variable remuneration, firms should adopt all necessary measures to prevent such practices from hampering their duty to act honestly, fairly and professionally.[25]

59. This approach can reinforce the control culture within firms and facilitate the alignment of the remuneration arrangement with its business strategy and culture. It is only through establishing the right culture within an organisation that senior management or, where appropriate, the supervisory function can convert good intentions into fair and sustainable outcomes for clients.

60. Supervisory experience suggests that when designing remuneration policies quantitative criteria are commonly used to assess performance of relevant persons, but qualitative criteria should also be used when assessing individual performance. While firms may choose to incentivise relevant persons in order to grow their businesses and increase profits, firms should also effectively control the risks that their remuneration policies and practices may pose to the fair treatment of clients. The performance of relevant persons should as a result not be solely assessed in relation to sales volumes or other financial criteria.

[25] In line with CRD III principle B that states "*remuneration policy should be in line with the business strategy, objectives, values and long-term interests of the credit institution, and incorporates measures to avoid conflicts of interest*".

IV. Controlling risks that remuneration policies and practices create

Overview

61. Firms must comply with the organisational requirements set out in Article 13 of MiFID in light of the MiFID conduct of business and conflicts of interest requirements. In accordance with this, a firm should plan its business structure appropriately so that it is able to identify, prevent, manage and control any risks arising from its remuneration policies and practices. Controls should be appropriately designed in order to provide senior management or, where appropriate, the supervisory function with sufficient comfort about the firm's compliance with the MiFID requirements.

62. Supervisory experience suggests that, in some cases, controls are not sufficiently robust to deter relevant persons from acting against the best interests of the client or to promote good outcomes for their clients. Firms do not always identify the key conduct of business and conflicts of interest risks arising in the provision of investment services and fail to tailor their existing controls to address them.

63. The remuneration policy must complement the business model and strategy of the investment firm as set out by senior management or, where appropriate, the supervisory function. Strategic decisions therefore must affect remuneration policies and practices.

64. Furthermore, supervisory experience demonstrates that some firms do not gather management information which identifies where poor practices could occur as a result of their remuneration practices. In cases where firms do identify the relevant risks, the poor practices are not always acted on or escalated to senior management or, where appropriate, the supervisory function. Senior management or, where appropriate, the supervisory function should be appropriately informed about any relevant issues regarding these topics. Such reporting should also help firms to react accordingly, by adopting corrective measures and controls on remuneration policies and practices.

Question

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.

65. Evidence gathered from ESMA's July 2011 remuneration questionnaire to supervisors highlighted a number of observed 'high risk' remuneration policies and practices. These incentives might influence relevant persons to sell, or 'push', one product, category of product rather than another. They include variable salaries and certain remuneration policies and practices that create a disproportionate return for marginal sales.

66. This section of the guidelines sets out the basis for the effective fulfilment of firms' responsibilities regarding controls, monitoring and reporting policies and practices with a view to taking all reasonable steps to prevent potential conduct of business and conflict of interest risks arising from their remuneration policies and practices.

Guidelines

67. Firms should set up adequate controls for compliance with the MiFID conflicts of interest and conduct of business requirements, including controls on implementation of their remuneration policies and practices to ensure that they deliver the intended outcomes. The controls should be implemented throughout the firm and subject to periodic review. Such controls should include assessing the quality of the service provided to the client, for example monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability or going through other client documentation on a regular basis.

Question

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.

68. Despite the care taken in designing and assessing remuneration policies and practices, some policies and practices still lead to client detriment, creating risks that need to be identified and mitigated. Where potential or actual detriment might arise as a result of specific features in remuneration policies and practices, firms should take appropriate steps to manage potential conduct of business and conflict of interest risks by reviewing and/or amending these specific features, and set up appropriate controls and reporting mechanisms for taking appropriate actions to mitigate potential conduct of business and conflict of interest risks.

69. Firms should ensure that they have appropriate and transparent reporting lines in place across the firm or group to assist in escalating issues involving risks of non-compliance with the MiFID conflicts of interest and conduct of business requirements.

70. The compliance function should be involved in the design process of remuneration practices before they are applied to relevant staff. It should also benefit from full support from senior management or, where appropriate, the supervisory function, so as to take necessary steps to ensure that relevant persons effectively comply with the conflicts of interest and conduct of business policies and procedures. Persons engaged in control functions should be independent from the business units they oversee, have appropriate authority, and should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.[26]

71. In order to control the design of remuneration practices and the approval process of the remuneration policies and practices, the compliance function should verify that firms comply with the MiFID conduct of business and conflicts of interest requirements, and should have access to all relevant documents.

Question

[26] See ESMA Guidelines on certain aspects of the MiFID compliance function requirements [ESMA/2012/388], and the EBA Guidelines on Internal Governance. [GL44].

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.

72. Examples of good practice:

- A firm uses a wide range of information on business quality monitoring and sales patterns, including trend and root-cause analysis, to identify areas of increased risk and to support a risk-based approach to sales monitoring, with particular focus on high performing relevant persons. The firm ensures that results of such analyses are documented and reported to senior management together with proposals for corrective action.

- In order to assess whether its incentive schemes are appropriate, a firm undertakes a programme of contacting a sample of customers shortly after the completion of a sale involving a face-to-face sales process where they are not able to monitor recorded telephone sales conversations, so as to test if the sales person has acted honestly, fairly and professionally in accordance with the best interests of the client.

- Top earners and performers are recognised as of potentially higher risk and as a result additional scrutiny is given to them; and information such as previous compliance results, complaints or cancellations data is being used to direct compliance checking. The outputs have an impact on the design/review of the remuneration policy and practices.

73. Example of poor practice:

- Senior management has set various strategic goals for the investment firm to be reached in a certain year. All goals seem to focus solely on financial or commercial aspects without taking into account the potential detriment to the firm's clients. The remuneration policy will be in line with these strategic goals and will therefore have a strong short-term financial and commercial focus.

74. Annex I includes illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which firms would therefore have difficulties demonstrating compliance with the MiFID requirements. The conduct of business and conflict of interest risks related to such examples should be taken into account by firms when designing and implementing their remuneration policies and practices.

Explanatory text

75. As highlighted in Annex I, certain remuneration features involve greater risk and in some situations such risks can be managed better than in others. For example, where a product being sold is frequently purchased and well understood by investors and there are strong controls in place, firms may be better able to manage the risks created by their remuneration practices than in other situations. In these cases, firms need to be aware about how specific features of their remuneration policies and practices could increase conduct of business and conflict of interest risk and put in place effective controls.

76. Firms should examine the basis of pay for any actual or prospective remuneration policies and practices and the extent to which they may affect compliance with the MiFID conduct of business and conflicts of interest requirements, and take appropriate action to correct or prevent it.

77. Support from senior management or, where appropriate, the supervisory function to the compliance staff will add gravitas and importance to the role performed by the compliance function and should in turn, lead to relevant persons taking more notice of conflicts management and best interest of the clients.[27]

78. Compliance function involvement and compliance controls are, however, only one part of the mechanisms firms need to set up in order to comply with the MiFID requirements. After having correctly designed the remuneration procedures, ensuring that these procedures are understood and applied correctly by the relevant persons will act as a first line of control, while controls for example by the internal audit function would act as a third line of control (compliance controls being of second line).

79. In order for senior management or, where appropriate, the supervisory function to be able to consider the risks which arise as a result of remuneration practices and reflect any subsequent changes, it is fundamental that there are clear reporting lines to senior management or, where appropriate, the supervisory function. Reporting lines would help firms to react accordingly, by adopting corrective measures and controls on remuneration policies and practices.

[27] See ESMA Guidelines on certain aspects of the MiFID compliance function requirements [ESMA/2012/388] and the EBA guidelines on Internal Governance.

Annex I: Illustrative examples of remuneration policies and practices that create conflicts that may be difficult to manage

1. This annex includes illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which firms would therefore have difficulties demonstrating compliance with the MiFID requirements. The conduct of business and conflict of interest risks related to such examples should be taken into account by firms when designing and implementing their remuneration policies and practices.

Examples of high risk remuneration policies and practices

2. Certain remuneration features (for example, the basis of pay, running performance-based competitions for relevant persons) involve higher risk of potential damage to clients than others (specifically those that include features which may have been designed to affect the behaviour of a sales force). Examples of high-risk remuneration policies and practices that will generally be difficult to manage, and where it would be very difficult for a firm to demonstrate compliance with MiFID, include:

   (a) Incentives that might influence the relevant persons to sell, or 'push', one product or category of product rather than another or to make unnecessary/unsuitable acquisitions or sales for the investor: especially situations where a firm launches a new product or pushes a specific product (e.g. the product of the month or "in-house products") and incentivises relevant persons to sell that specific product. Where the incentive is different for different types of products there is a high risk that relevant persons will favour selling the higher earning product in place of another product without appropriate regard to what is in the client's best interests.

   <u>Example a1</u>: A firm has remuneration policies and practices linked to individual product sales where the relevant person receives different levels of incentives depending on the specific product or category of products they sell.

   <u>Example a2</u>: A firm has remuneration policies and practices linked to individual product sales, where the relevant person receives the same level of incentive across a range of products. However, at certain limited times, to coincide with promotional or marketing activity, the firm increases the incentive paid on the sales of certain products.

   <u>Example a3</u>: Incentives that might influence relevant persons (who may be remunerated solely by commission, for example) to sell unit trusts rather than investment trusts – where both products may be equally suitable for clients - because sales of unit trusts pay substantially higher commissions.

   (b) Inappropriate requirements that affect whether incentives are paid: remuneration policies and practices which include, say, a requirement to achieve a quota of minimum sales levels across a range of products in order to earn any bonus at all is likely to be incompatible with the duty to act in the best interests of the client. Conditions which must be met before an incentive will be paid may influence relevant persons to sell inappropriately. For example, where no bonus can be earned on sales unless a minimum target is met for each of several different product types, this may impact on whether suitable products are recommended. Another example is where a reduction is made to a bonus or incentive payments earned because a secondary target or threshold has not been met.

Example b1: A firm has relevant persons who sell a range of products that meet different client needs, and the product range is split into three 'buckets' based on the type of client need. Relevant persons can accrue incentive payments for each product sold, however at the end of each monthly period no incentive payment is made if they have not reached at least 50% of the sales target set for each 'bucket'.

Example b2: A firm sells products with a range of optional 'add-on' features. The relevant person receives incentive payments for all sales, with an additional payment if the client purchases an add-on feature. However at the end of each monthly period no incentive payment is made if they have not achieved a penetration rate of at least 50% of products sold with an add-on feature.

(c) Variable salaries where the arrangements vary base pay (up or down) for relevant persons based on performance against sales targets: In such cases, the relevant person's entire salary can become – in effect – variable remuneration.

Example c1: A firm will reduce a relevant person's basic salary substantially if he does not meet specific sales targets. There is therefore a risk that he or she will make inappropriate sales to avoid this outcome. Equally, relevant persons may be strongly motivated to sell by the prospect of increasing basic salary and associated benefits.

(d) Remuneration policies and practices which create a disproportionate return for marginal sales: where relevant persons need to achieve a minimum level of sales before incentive payments can be earned, or incentives are increased, the risk is increased. Another example would be schemes that include 'accelerators' where crossing a threshold increases the proportion of bonus earned. In some cases, incentives are payable retrospectively based on all sales rather than just those above a threshold, potentially creating significant incentives for relevant persons to sell particular products in particular circumstances.

Example d1: A firm makes accelerated incentive payments to relevant persons for each product sold during a quarterly period as follows:

- 0-80% of target — no payments
- 80-90% of target — 50 € per sale
- 91-100% of target — 75 € per sale
- 101-120% of target — 100 € per sale
- >120% of target — 125 € per sale

This example can also apply where the relevant person receives an increasing share of commission or income generated.

Example d2: A firm has the same accelerated scale as the firm in example d1, but the increase in payments per sale is applied retrospectively to all sales in the quarter, e.g. on passing 91% of target the incentive payments accrued to date at the rate of €50 per sale are increased to €75 per sale. This creates a series of 'cliff edge' points, where one additional sale required to reach a higher target band causes a disproportionate increase in the incentive payment.

Questions

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 1 above which specific requirements (i.e. stronger controls, etc) they should be subject to.

Annex II: List of consultation questions

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.

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.

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?

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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

Annex III: Cost-benefit analysis

1. Article 16 of the ESMA Regulation[28] requires ESMA, where appropriate, to analyse the potential costs and benefits relating to proposed guidelines. It also states that cost-benefit analyses must be proportionate in relation to the scope, nature and impact of the proposed guidelines.

2. On the basis of the analysis we have conducted we expect some compliance costs will be incurred by regulators and firms in order to fully incorporate the guidelines in their supervisory practices and remuneration policies. The main benefits will be for customers that will derive from the diffusion of remuneration structures that will stimulate firms' management and employees to act in the best interest of the client, elevating quality standards and avoiding inappropriate behaviour. ESMA expects changes and costs to materialise mainly for firms that are currently non-compliant with existing MiFID regulatory requirements.

3. ESMA believes that sound remuneration policies are fundamental in guaranteeing a high level of protection offered to investors and eliminating perverse incentives that can lead to practices such as mis-selling of financial products which are not appropriate for investors, or investment choices which are sub-optimal.[29] [30]

4. The purpose of the draft guidelines is to set out relevant organisational and conduct of business requirements that firms should follow when setting and operating remuneration structures.

5. The guidelines take into account the existing MiFID organisational requirements that compel investment firms to establish policies and procedures sufficient to ensure the firm complies with its obligations under the Directive (including its obligations regarding the reasonable steps the firm must take to prevent conflicts of interest from adversely affecting the interests of its clients).[31] [32] [33]

6. By providing clarification of the relevant MiFID organisational requirements, ESMA is helping firms to improve their implementation of these requirements. Convergence to better standards due to convergence in supervisory approaches and firm behaviour leads to improved investor protection (consumer outcomes), which is a key ESMA objective.

Compliance costs

[28] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

[29] See CESR's response to CEBS consultation paper (CP42) on 'Guidelines on Remuneration Policies and Practices' (November 2010).

[30] The European Commission stated in the 'Impact Assessment' accompanying the proposed recast of the MiFID Directive (20 October 2010) that *"It would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID.*"

[31] See Directive 2004/39/EC - Article 13(3): *"An investment firm shall maintain and operate effective organisational and administrative policies and practices with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients."*

[32] See Directive 2004/39/EC - Article 13(3): *"An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients."*

[33] See Directive 2006/73/EC – Article 22(3): "[…] *the procedures to be followed and measures to be adopted shall include such of the following as are necessary and appropriate for the firm to ensure the requisite degree of independence:* […] *(c) the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities."*

7. The detailed implementation of the guidelines is likely to lead to some additional costs for regulators to the extent that competent authorities will be required to incorporate them into their supervisory practices. The authorities will however benefit from having a clearer framework against which to assess firms' compliance with Articles 13(3), 18 and 19(1) of MiFID.

8. The detailed implementation of the guidelines may also lead to some compliance costs for firms that will be mainly incurred initially.[34] Compliance costs will primarily arise from the possible need to change the way remuneration policies are set out and from the time needed for existing personnel (mainly, but not exclusively, the compliance function) to familiarise themselves with the guidelines and to put the necessary structures in place.

9. Firms may also be required to change employment contracts and bonuses may need to be renegotiated if not in line with the guidelines. However the implementation costs of the guidelines are estimated[35] as too low to have any relevant impact on firms. If high costs should emerge, the reason for this would be non-compliance with existing MiFID regulatory requirements.

Benefits

10. Benefits are potentially significant even if difficult to quantify, due to the nature of the topic. The impact analysis can only be qualitative in nature.

11. Benefits will mainly arise from changes in behaviour from firms that are currently not complying with MiFID rules. Benefits for customers will descend from the diffusion of remuneration structures that will stimulate firms' management and employees to act in the best interest of the client, elevating quality standards and avoiding inappropriate behaviour. Clients are expected to benefit because the measures should result in an overall improvement in the quality of advice and therefore to more suitable sales. The absence of clarity in regulation and failure to address the current situation would instead feed uncertainty potentially increasing the number of cases of mis-selling of financial services.

[34] The UK FSA conducted a detailed cost-benefit analysis in 2009 (CP09/10), when proposing its reformed remuneration practices in financial services, and the results indicated initial costs in a range of £155,000 to £2.5m and incremental annual compliance costs between £170,000 and £2.3m depending on the complexity of the organisation.

[35] See UK FSA CP09/10 – Annex 4.

Annex IV: Questionnaire to supervisors of investment firms

Remuneration of staff involved in the provision of investment services: compliance with conduct of business and conflicts of interest rules

Question 1: Remuneration practices

In this section, we would like to gather information from you/supervisors regarding specific practices that raise concerns with you as supervisors.

1. What types of common remuneration policies and practices by firms have you observed as a supervisor?

(a) Have you observed practices which you consider to be high risk or unacceptable; and how do you communicate such an assessment to firms?

(b) Regarding existing remuneration policies set up by firms, do non-financial, as well as financial, criteria (such as compliance with regulation and internal rules, market conduct standards, fair treatment of investors, etc) impact on employee remuneration and to an appropriate extent? What are these criteria? If those criteria do not impact (or not to an appropriate extent) on employee remuneration, are there any legitimate reasons for this (e.g. level of risk, other offsetting measures applied by firms)?

(c) Do you supervise MiFID requirements[36] on conflicts of interest and conduct of business obligations in order to verify the impact of remuneration structures on the risk of damage to clients' interests? If so, how do you do this?

(d) Have you identified any remuneration practices that you believe are not compatible with the existing MiFID requirements, or should be subject to specific requirements (stronger controls, etc)? If so, please describe those practices and any penalties or remedies imposed on the firms.

(e) Have you considered the impact of other requirements (beyond MiFID) and/or of more prudential focused rules (e.g. CRD III) on conduct of business? If so, please describe to what extent.

[36] Articles 13(3), 18 and 19 of MiFID and Article 22 of the MiFID Implementing Directive.

Question 2: Sales targets and other reward arrangements

In this section we would like to collect information on the way that employees are appraised and the targets they are set.

2. Are firms taking into account the interests of the customer in setting sales targets?

(a) Do firms consider whether their approaches to performance management and target setting increase the risk of mis-selling (i.e. failing to comply with Articles 13(3), 18 or 19 of MiFID - for example, by withholding information from investors or giving unsuitable advice)?

(b) Do firms' targets incorporate measures of regulatory compliance and fair treatment of clients? i.e. are employees appraised taking into account not only quantitative criteria, but also qualitative criteria? Have you seen examples of how this is monitored by the firm? What kind of qualitative criteria are used?

(c) Do sales targets encourage bias towards products which are easier, quicker or more profitable to sell and where there might be a risk of mis-selling to the consumer? Please provide examples of targets or other factors that could lead to undue pressure on sales staff.

(d) Is variable remuneration of employees common and how significant is it? Please provide any information you have on the proportion of remuneration that is variable for staff involved in providing investment services. If available, please also provide any information about how variable remuneration is calculated.

(e) Is variable remuneration rewarded on a conditional basis? If so, what are these conditions?

(f) In the appraisal procedure/when assessing the performance realised by an employee, does the firm take into account the performance realised by the employee alone and/or the performance realised by the branch/department to which the employee is attached? Are there any indications apart from the appraisal methods that the firm is not acting in the client's best interests?

Question 3: Governance of remuneration arrangements

In this section, we would like to collect information on how arrangements are developed in order to tackle conduct risk associated with remuneration.

3. In developing reward arrangements, do firms identify the risks that their remuneration practices give rise to – including the potential for mis-selling?

(a) Do firms have procedures in place to determine and review remuneration systems in a clear, well documented and internally transparent way?

(b) Do firms have staff in appropriate functions, with the right skills and knowledge, dealing with the approval of the reward structure?

(c) Does the reward structure incentivise employees to accomplish their tasks in a reliable manner, acting in their clients' interests and mitigating any conduct of business risks?

(d) How do firms' internal rules, outside their formal remuneration policies, affect remuneration in practice?

Question 4: Controlling the risks that remuneration structures can/could create

In this section, we would like to collect information on the types of controls that have been developed to manage the conduct of business risks created by remuneration schemes:

4. Do firms' compliance policies and controls adequately manage the conduct of business risks posed by their activities at all levels?

(a) Do firms consistently apply action where an employee (e.g. an adviser or portfolio manager) falls below expected quality standards? If so, please describe examples of different measures (such as disciplinary actions, reduction of salary, etc) being taken.

(b) Do firms draw on information about remuneration being paid in conducting compliance checks – e.g. by checking more files of advisers/portfolio managers that suddenly begin to earn higher sums?

(c) Is analysis of complaints prominent in the firms' approaches to mitigating risk and do firms take action to address systemic issues where adverse behaviour has arisen?

(d) How are the compliance function and/or firm's internal governance (e.g. a remuneration committee) involved in assessing remuneration of sales staff from the conduct of business perspective?

(e) Do you believe that high risk remuneration practices can be offset by firms employing effective checks and balances (e.g. strict controls and penalties for quality failures)?

Annex V: Draft guidelines

I. Scope

1. These guidelines apply to

   a. investment firms (as defined in Article 4(1)(1) of MiFID), as well as

   b. credit institutions, UCITS management companies and external Alternative Investment Fund Managers (AIFMs) when providing investment services[37]), and

   c. competent authorities.

2. These guidelines apply in relation to the provision of the investment services listed in Section A of Annex I of the Markets in Financial Instruments Directive (MiFID) and ancillary services listed in Section B thereof.

3. Although these guidelines principally address situations where services are provided to retail clients, they should also be considered as applicable, to the extent they are relevant, when services are provided to professional clients (MiFID Articles 13 and 18 apply irrespective of the retail or professional nature of the clients).

4. These guidelines apply from 60 calendar days after the reporting requirement date referred to in paragraph 11.

II. Definitions

5. Unless otherwise specified, terms used in the Markets in Financial Instruments Directive have the same meaning in these guidelines. In addition, the following definitions apply:

competent authority	An authority designated by a Member State under Article 48 of the Markets in Financial Instruments Directive to carry out the duties provided for under MiFID.
Markets in Financial Instruments Directive	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.
MiFID Implementing Directive	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

[37] These guidelines only apply to UCITS management companies and AIFMs when they are providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD).

ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.
senior management	The person or persons who effectively direct the business of the investment firm (see Article 2(9) of the MiFID Implementing Directive).

6. Guidelines do not reflect absolute obligations. For this reason, the word 'should' is often used. However, the words 'must' or 'are required' are used when describing a MiFID requirement.

III. Purpose

7. The purpose of these guidelines is to ensure the consistent and improved implementation of the existing MiFID conflicts of interest and conduct of business requirements in the area of remuneration. They address, in particular, Articles 13(3), 18 and 19 of MiFID, and Articles 21, 22 and 23 of the MiFID Implementing Directive.

8. ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID conflicts of interest and conduct of business requirements in the area of remuneration by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.

IV. Compliance and reporting obligations

Status of the guidelines

9. This document contains guidelines issued under Article 16 of the ESMA Regulation[38]. In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with the guidelines.

10. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

Reporting requirements

11. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to [email address]. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.

[38] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

12. Financial market participants are not required to report whether they comply with these guidelines.

V. Guidelines on remuneration policies and practices (MIFID)

V.I Governance and design of remuneration policies and practices in the context of the MiFID conduct of business and conflicts of interest requirements

13. When designing or reviewing remuneration policies and practices, firms should consider the conduct of business and conflicts of interest risks that may arise. A firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties (to include avoiding conflicts of interests deliberately created by the policies and practices) and conduct of business risk management obligations, in order to ensure that clients' interests are not impaired by the remunerations policies and practices adopted by the firm in the short, medium and long term.

14. Remuneration policies and practices should be designed in such a way 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.

15. In the design of the remuneration policies and practices, firms should consider all relevant factors such as the role performed by relevant persons, the type of products offered, and the methods of distribution (e.g. advised or non-advised, face-to-face or through telecommunications) in order to prevent potential conduct of business and conflict of interest risks from adversely affecting the interests of their clients and to ensure that the firm adequately manages any related residual risk...

16. When designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced. Furthermore, the remuneration mechanisms in place should allow the operation of a flexible policy on variable remuneration, including, where appropriate, the possibility to pay no variable remuneration at all.

17. High variable remuneration can increase the relevant person's focus on short-term gains rather than the client's best interest. The ratio between the fixed and variable components of the remuneration received should therefore be appropriate in order to take into account the interests of all stakeholders (including firms' clients).

18. Where remuneration is, in part, variable, firms' remuneration policies and practices should define appropriate criteria to be used to assess the performance of relevant persons. Such assessment should be based on both financial (quantitative) and non-financial (qualitative) criteria encouraging the relevant persons to act in the best interests of the client.[39] Examples of non-financial (qualitative) criteria include compliance with regulatory requirements and internal procedures, market conduct standards, fair treatment of clients and business retention.

19. Furthermore, where a firm's policy provides for variable remuneration, the firm should adopt and maintain measures enabling it to promptly identify where the relevant person fails to act in the best interests of the client and to take remedial action.

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[39] In line with CRD III principle G that states *'where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individuals performance, financial as well as non- financial criteria are taken into account'.*

20. In determining the performance of relevant persons firms should also take into account the outcome of their activities in terms of compliance with the conduct of business rules and, in general, with the duty to care about the best interests of their clients.

21. 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, and implemented by appropriate functions to promote effective corporate governance. There should be effective oversight in place within the firm to approve the remuneration policies and practices. Senior management should be responsible for the implementation of remuneration policies and practices and for preventing and dealing with any risks that remuneration policies and practices can create.[40]

22. Relevant persons should be clearly informed at the outset of the criteria that will be used to determine the amount of their remuneration and the steps and timing of their performance reviews. The criteria used by firms to assess the performance of relevant persons should be accessible, understandable and recorded.

23. Firms should avoid creating unnecessarily complex policies and practices (such as combinations of different policies and practices, or multi-faceted schemes, which increase the risk that relevant persons' behaviour will not be driven in the way firms intend, and that any controls in place will not be as effective to identify the risk of detriment to the client). This may potentially lead to inconsistent approaches and hamper proper knowledge or control of the policies by the compliance function. Annex I of the draft guidelines sets out illustrative examples of remuneration policies and practices that create risks that may be very difficult to manage due to their complexity and strong incentives to sell specific products.

24. Firms should have written remuneration policies which should be periodically reviewed.

25. Examples of good practice:

- The variable part of the remuneration paid out is calculated and awarded on a linear basis rather than being dependent on meeting an 'all or nothing' target. In some cases, the firm decides to pay out the variable remuneration in several tranches over an appropriate time period, in order to adjust for and take into account the long term results.

- A firm has fundamentally changed the ratio between fixed and variable income. The variable component of the remuneration has been considerably reduced and the fixed part of the income has been increased. The new ratio more closely reflects the desired conduct of the employees to act in the best interests of clients.

- When offering additional incentive payments for reaching required levels of sales, a firm takes into account whether the relevant person meets the firm's quality standards or standards of compliance - such as, rates of business retention (or lapses); whether it upholds any complaints about advice etc.

[40] In line with CRD III principle C that states *'the management body in its supervisory function of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation'*.

- References used in the calculation of variable remuneration of staff are common across products sold and include qualitative criteria.

26. Examples of poor practice:

- A firm has started offering advisers specific additional remuneration to encourage clients to apply for new fund products in which the firm has a specific interest. This often involves the relevant person having to suggest that their clients sell products that they would otherwise recommend they retain so they can invest in these new products.

- A firm sells investment products with an inappropriate balance of risk and reward for the clients in question. Warnings of the risk manager are ignored because the investment products generate high returns for the firm. Managers and employees therefore receive a large bonus. When the risks that had been identified occur, the bonuses have already been paid out.

V.II Controlling risks that remuneration policies and practices create

27. Firms should set up adequate controls for compliance with the MiFID conflicts of interest and conduct of business requirements, including controls on implementation of their remuneration policies and practices to ensure that they deliver the intended outcomes. The controls should be implemented throughout the firm and subject to periodic review. Such controls should include assessing the quality of the service provided to the client, for example monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability or going through other client documentation on a regular basis.

28. Despite the care taken in designing and assessing remuneration policies and practices, some policies and practices still lead to client detriment, creating risks that need to be identified and mitigated. Where potential or actual detriment might arise as a result of specific features in remuneration policies and practices, firms should take appropriate steps to manage potential conduct of business and conflict of interest risks by reviewing and/or amending these specific features, and set up appropriate controls and reporting mechanisms for taking appropriate actions to mitigate potential conduct of business and conflict of interest risks.

29. Firms should ensure that they have appropriate and transparent reporting lines in place across the firm or group to assist in escalating issues involving risks of non-compliance with the MiFID conflicts of interest and conduct of business requirements.

30. The compliance function should be involved in the design process of remuneration practices before they are applied to relevant staff. It should also benefit from full support from senior management or, where appropriate, the supervisory function, so as to take necessary steps to ensure that relevant persons effectively comply with the conflicts of interest and conduct of business policies and procedures. Persons engaged in control functions should be independent from the business units they oversee, have appropriate authority, and should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control.[41]

[41] See ESMA Guidelines on certain aspects of the MiFID compliance function requirements [ESMA/2012/388], and the EBA Guidelines on Internal Governance. [GL44].

31. In order to control the design of remuneration practices and the approval process of the remuneration policies and practices, the compliance function should verify that firms comply with the MiFID conduct of business and conflicts of interest requirements, and should have access to all relevant documents.

32. Examples of good practice:

- A firm uses a wide range of information on business quality monitoring and sales patterns, including trend and root-cause analysis, to identify areas of increased risk and to support a risk-based approach to sales monitoring, with particular focus on high performing relevant persons. The firm ensures that results of such analyses are documented and reported to senior management together with proposals for corrective action.

- In order to assess whether its incentive schemes are appropriate, a firm undertakes a programme of contacting a sample of customers shortly after the completion of a sale involving a face-to-face sales process where they are not able to monitor recorded telephone sales conversations, so as to test if the sales person has acted honestly, fairly and professionally in accordance with the best interests of the client.

- Top earners and performers are recognised as of potentially higher risk and as a result additional scrutiny is given to them; and information such as previous compliance results, complaints or cancellations data is being used to direct compliance checking. The outputs have an impact on the design/review of the remuneration policy and practices.

33. Example of poor practice:

- Senior management has set various strategic goals for the investment firm to be reached in a certain year. All goals seem to focus solely on financial or commercial aspects without taking into account the potential detriment to the firm's clients. The remuneration policy will be in line with these strategic goals and will therefore have a strong short-term financial and commercial focus.

34. Annex I includes illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which firms would therefore have difficulties demonstrating compliance with the MiFID requirements. The conduct of business and conflict of interest risks related to such examples should be taken into account by firms when designing and implementing their remuneration policies and practices.

V.III **Annex I: Illustrative examples of remuneration policies and practices that create conflicts that may be difficult to manage**

35. This annex includes illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which firms would therefore have difficulties demonstrating compliance with the MiFID requirements. The conduct of business and conflict of interest risks related to such examples should be taken into account by firms when designing and implementing their remuneration policies and practices.

Examples of high risk remuneration policies and practices

36. Certain remuneration features (for example, the basis of pay, running performance-based competitions for relevant persons) involve higher risk of potential damage to clients than others (specifically

those that include features which may have been designed to affect the behaviour of a sales force). Examples of high-risk remuneration policies and practices that will generally be difficult to manage, and where it would be very difficult for a firm to demonstrate compliance with MiFID, include:

(e) Incentives that might influence the relevant persons to sell, or 'push', one product or category of product rather than another or to make unnecessary/unsuitable acquisitions or sales for the investor: especially situations where a firm launches a new product or pushes a specific product (e.g. the product of the month or "in-house products") and incentivises relevant persons to sell that specific product. Where the incentive is different for different types of products there is a high risk that relevant persons will favour selling the higher earning product in place of another product without appropriate regard to what is in the client's best interests.

Example a1: A firm has remuneration policies and practices linked to individual product sales where the relevant person receives different levels of incentives depending on the specific product or category of products they sell.

Example a2: A firm has remuneration policies and practices linked to individual product sales, where the relevant person receives the same level of incentive across a range of products. However, at certain limited times, to coincide with promotional or marketing activity, the firm increases the incentive paid on the sales of certain products.

Example a3: Incentives that might influence relevant persons (who may be remunerated solely by commission, for example) to sell unit trusts rather than investment trusts – where both products may be equally suitable for clients - because sales of unit trusts pay substantially higher commissions.

(f) Inappropriate requirements that affect whether incentives are paid: remuneration policies and practices which include, say, a requirement to achieve a quota of minimum sales levels across a range of products in order to earn any bonus at all is likely to be incompatible with the duty to act in the best interests of the client. Conditions which must be met before an incentive will be paid may influence relevant persons to sell inappropriately. For example, where no bonus can be earned on sales unless a minimum target is met for each of several different product types, this may impact on whether suitable products are recommended. Another example is where a reduction is made to a bonus or incentive payments earned because a secondary target or threshold has not been met.

Example b1: A firm has relevant persons who sell a range of products that meet different client needs, and the product range is split into three 'buckets' based on the type of client need. Relevant persons can accrue incentive payments for each product sold, however at the end of each monthly period no incentive payment is made if they have not reached at least 50% of the sales target set for each 'bucket'.

Example b2: A firm sells products with a range of optional 'add-on' features. The relevant person receives incentive payments for all sales, with an additional payment if the client purchases an add-on feature. However at the end of each monthly period no incentive payment is made if they have not achieved a penetration rate of at least 50% of products sold with an add-on feature.

(g) Variable salaries where the arrangements vary base pay (up or down) for relevant persons based on performance against sales targets: In such cases, the relevant person's entire salary can become – in effect – variable remuneration.

Example c1: A firm will reduce a relevant person's basic salary substantially if he does not meet specific sales targets. There is therefore a risk that he or she will make inappropriate sales to avoid this outcome. Equally, relevant persons may be strongly motivated to sell by the prospect of increasing basic salary and associated benefits.

(h) Remuneration policies and practices which create a disproportionate return for marginal sales: where relevant persons need to achieve a minimum level of sales before incentive payments can be earned, or incentives are increased, the risk is increased. Another example would be schemes that include 'accelerators' where crossing a threshold increases the proportion of bonus earned. In some cases, incentives are payable retrospectively based on all sales rather than just those above a threshold, potentially creating significant incentives for relevant persons to sell particular products in particular circumstances.

Example d1: A firm makes accelerated incentive payments to relevant persons for each product sold during a quarterly period as follows:

- 0-80% of target — no payments
- 80-90% of target — 50 € per sale
- 91-100% of target — 75 € per sale
- 101-120% of target — 100 € per sale
- >120% of target — 125 € per sale

This example can also apply where the relevant person receives an increasing share of commission or income generated.

Example d2: A firm has the same accelerated scale as the firm in example d1, but the increase in payments per sale is applied retrospectively to all sales in the quarter, e.g. on passing 91% of target the incentive payments accrued to date at the rate of €50 per sale are increased to €75 per sale. This creates a series of 'cliff edge' points, where one additional sale required to reach a higher target band causes a disproportionate increase in the incentive payment.