CFA INSTITUTE | Centre for Financial Market Integrity

The Committee of European Securities Regulators
11-13 avenue de Friedland
75008 Paris
France

21st December 2009

Inducements: Good and poor practices – Consultation Paper

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the Committee of European Securities Regulators ("CESR") consultation on "Inducements: Good and poor practices" (the "Consultation"). This consultation concerns the interpretation and application of the MiFID inducements rules as described by Article 26 of the Level 2 directive and the search for best practice.

The CFA Institute Centre[1] promotes fair, open, and transparent global capital markets, and advocates for investor protection. We support CESR's efforts, via survey and this consultation to examine industry practice on the interpretation and application of the MiFID inducements rules. We share CESR's hope that at the conclusion of this project, the industry will have a much clearer understanding of best practice, and that the benchmark of behaviour will ratchet up to deliver a better customer experience.

CFA Institute is committed to raising ethical conduct and professional standards. This commitment manifests itself at the member level through the CFA program curriculum with our "Standards of Practice Handbook[2]". For the benefit of investment firms and non-members, we have written and published our "Asset Manager Code of Professional Conduct[3]".

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[2] http://www.cfapubs.org/toc/ccb/2005/2005/3

[3] http://www.cfainstitute.org/centre/codes/asset/index.html

CFA INSTITUTE | Centre for Financial Market Integrity

Executive Summary

- Placing the interests of the customer first and making candid disclosure to the client are aspects of good ethics and professional standards, hence our interest in this study of industry practice on inducements.

- The effective implementation of the inducements rules depends on ongoing and proactive input from the compliance department. To assure its authority in managing these rules the compliance department needs the backing of senior management.

- Proper fees as described in Article 26(c) must be unbundled to demonstrate that the fees are necessary to the provision of the investment service.

- Article 26(b) concerns payments to third parties that are 'designed to enhance the quality of the service to the client'. This clause seems to be the least understood or the most broadly interpreted by firms. We feel that CESR needs to offer *firm* guidance on what is good practice.

- Finally, retail investors ought to have access to the same degree of disclosure as professional investors. The challenge for firms is to make these disclosures clear, comprehensive and understandable by the avoidance of jargon.

We attach our response that addresses the specific questions of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

Charles Cronin, CFA
Head, CFA Institute Centre
Europe, Middle East and Africa

+44 (0)20 7531 0762
charles.cronin@cfainstitute.org

Rhodri G. Preece, CFA
Director, Capital Markets Policy
CFA Institute Centre

+44 (0)20 7531 0764
rhodri.preece@cfainstitute.org

Register of Interested Representatives # **89854211497-57**

The CFA Institute Centre is part of CFA Institute[4]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 139 countries, of whom more than 88,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

For the benefit of readers who do not have access to CESR's consultation paper, we included the text of Article 26 of the MiFID implementing directive ("Level 2 Directive") that concerns inducements, as an addendum to our specific comments.

Specific Comments

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

> ***Question I***: *Do you agree with CESR's views about the arrangements and procedures an investment firm should set up?*

Article 26 prescribes monetary and non-monetary benefits/payments into three categories: between the client and the firm, the firm and third parties, and proper fees that are obligatory in order to deliver the investment process. We agree with CESR that to comply with the directive firms must identify, classify and evaluate benefits and payments that fall within the scope of the directive. Conversely, they must also have procedures to prevent any payments or benefits that fall outside the scope of the directive. The firm's compliance department must take an active role in this process in order to achieve these goals.

> ***Question II***: *Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?*

We are supportive of CESR's views concerning specific responsibilities and compliance controls. The above policies and procedures need to be assessed on an ongoing basis. We entirely agree with CESR that senior management of the firm should support the compliance function. Without this support, the compliance department will not have the authority to challenge the firm's adherence to the directive.

[4] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

***Question III**: What are your comments about CESR's view that at least the general approach the investment firm is going to undertake regarding inducements ("its inducement's policy") should be approved by senior management?*

Fundamental to the client/investment firm 'contract' is the understanding that the client's funds (after agreed charges) will be used for the client's benefit and that there should be candid disclosure by the investment manager to the client. Hence, to make sure the firm acts in the best interest of the client it is crucial that senior management set the ethical tone of the firm. It is only by senior management example that the more junior staff will recognise and internalise the values of their employer.

CFA Institute has given this 'contract' considerable attention. To help resolve these issues of client duty we wrote and published our Asset Manager Code of Professional Conduct[5]. The following procedures are applicable in the Asset Manager Code:

A. 1 - Managers must place client interests before their own,

C.3 - Managers must use commissions generated from client trades to pay for only investment-related products or services that directly assist the Manager in its investment decision making process, not in the management of the firm,

F.2 - Managers must ensure that disclosures are truthful, accurate, complete, and understandable, and are presented in a format that communicates the information effectively,

F. 4 – Managers must disclose the following,

a) conflicts of interest generated by any relationships with brokers or other entities, other client accounts, fee structures or other matters,

d) management fees and other investment costs charged to investors, including what costs are included in the fees and the methodologies for determining fees and costs,

e) the amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.

[5] http://www.cfainstitute.org/centre/codes/asset/index.html

Proper fees:

> ***Question IV**: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?*

Under the directive 'Proper fees' are defined as payments which i) enable or are necessary for the provision of investment services and ii) by their nature cannot give rise to conflicts with the firms' duty to clients. We agree with CESR that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible as proper fees, with two caveats. Firstly these fees must be unbundled from any other services and secondly that the client is receiving benefit for access to that venue. In both instances, an appropriate example would be where the client has purchased units in a European fund, and the firm has purchased 'global' access to trading venues and data feeds. As a holder of European units, the client only receives partial benefit from the costs he accrues from the firm's decision to make a bundled purchase to gain access to global trading venues. We do not feel the client should be charged for a bundled package, where he only enjoys partial benefit. This is not a proper fee, it more likely falls under the scope of Article 26(b), and should be considered under the 'designed to enhance' criteria. Proof would be where a bulk purchase creates an overall saving for the client.

> **Question V**: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?

Yes.

> **Question VI**: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?

We are not experts in taxation and therefore do not offer an opinion.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the services provided to the client:

> **Question VII**: Do you agree with CESR's view that in case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?

Yes, we agree with CESR, the concept of ongoing payments based on a one-off benefit to the client seems inconsistent with the operation of an asset manager business. A series of payments to an introducer of a client from an asset manager could be conceived as a retainer, to encourage client retention. We find it hard to imagine how these payments would be consistent with the directive requirement [Article 26(b)ii] that such inducements must be designed to enhance the quality of the service and be in the client's best interest.

> **Question VIII**: Do you have any comments regarding CESR's view that measures such as an effective compliance function should be backed up with appropriate monitoring and controls to deal with the specific conflicts that payments and non-monetary benefits provided or received by an investment firm can give rise to?

Clearly, the range of Article 26 benefits and payments is not static in number nor in description. Therefore, the firm's compliance function cannot be complete without a real time monitoring system that interrogates any new type of payment or benefit.

> **Question IX**: Do you have any comments regarding CESR's view that product distribution and order handling services (see §74) are two highly important instances where payments and non-monetary benefits received give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?

We strongly support CESR's opinion that the circumstances outlined in paragraph 74, give rise to potential conflicts, namely investment advisers receiving benefits from product providers and the situation where portfolio managers receive benefits from product providers and firms offering brokerage services. We would strengthen CESR's text to describe these examples as 'conflicted environments'.

We offer another instance, which creates a conflicted environment. This occurs where a service is offered in exchange for soft commission that is accompanied by incidental personal benefits. This is touched upon in bullet points 7 and 8 of paragraph 74, 'the receipt of soft commissions for (7) research and (8) training purposes'. While research and training has its merits, a conflict arises if it is conducted in lavish hotels, at desirable locations, with

attractive events. Such research and training events are commonly described as conferences. The recipients of this research and training may find their objectivity compromised by the previous event and their anticipated pleasure for a future event. Firms need to have strict guidelines governing these events to retain the objectivity of their employees.

CFA Institute members must annually affirm to our Code of Ethics and Standards of Professional Conduct. Ethics and Professional Conduct are a core part of the CFA curriculum. The Standards of Practice Handbook[6] (the course textbook) contains many examples of ethical dilemmas and guidance of how these can be avoided. CESR may care to study the Handbook, which is free to download, as a source of further inspiration.

> **Question X**: Do you have any comments regarding CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?

We agree with CESR. There is something unwholesome about charges that are not immediately apparent to the client, but only become apparent through the fine print. The rationale would appear that full disclosure would undermine the competitive position of the product. Our opinion is that these fees, described as 'fund-picking fees' and informational charges are retrocessions by another name. We fail to comprehend how these charges enhance the quality of service. If a charge is obligatory then this must be disclosed 'upfront' as part of the primary fee structure.

Payments and non-monetary benefits authorised to certain cumulative conditions - Disclosure:

> **Question XI**: Do you have any comments on CESR's views about summary disclosures (including when they should be made)?

In reference to Article 26(b)i, we agree with CESR's ambition to clarify 'summary form' disclosure of third party payments/benefits. Namely, these disclosures should be clear, accurate and understandable, reference that detailed disclosure is available on request, and delivered before the customer commits to the service. We would clarify that this is not at the point of signing an agreement, but presented ahead of time as material information as part of the customer's decision-making process.

> **Questions XII**: What are your comments on CESR's views about detailed disclosures?

[6] http://www.cfapubs.org/toc/ccb/2005/2005/3

We believe that CESR's position on detailed disclosure is very reasonable: specifically, the detailed disclosure should cover all types of third party payments and benefits, where possible exact amounts of payments/benefits should be quoted, and the disclosures should be written concisely and unambiguously.

> **Question XII**: What are your comments on CESR's views on the use of bands?

Broadly, we agree that bands should be used where precise information is unavailable. We would like some assurance that the firm has only resorted to using bands after some confirmation to the supervisory authority that proves precise values would be impossible to display. We note CESR's comments on dispersion and clustering of payments and benefits in broad bands that have the capacity to mislead investors. Similarly, we note the opportunity to mask scale differences of in-house and third party payments/benefits by using broad bands. Concerning maximum levels, our preference is that these should not be permitted. These payments/benefits are more appropriately described under the banding criteria.

> **Question XIV**: Do you agree with CESR's views on the documentation through which disclosures are made?

We agree with CESR's two-step approach to summary and detailed disclosure, with summary disclosure at the beginning of the marketing process, followed by detailed information as the client moves towards closing the transaction. Note, as stated in our answer to question XI, detailed disclosure should not be provided at the point of commitment, but at a time prior so that the information conveyed can be usefully incorporated into the client's investment decision-making process.

We agree that investment firms should make use of websites for disclosure purposes, but these sources of information should compliment and not substitute hardcopy where the customer receives hardcopy in the marketing process.

> **Question XV**: Do you agree with CESR's views on the difference of treatment between retail and professional clients?

We believe that both professional and retail investors should receive the same level of disclosure. We are not convinced by arguments that detailed information would be too technical for the comprehension of retail investors. A feature of good disclosure is that it should be well written; that is clear, comprehensive and understandable. Particular attention to avoid jargon would assist this cause.

Addendum

ANNEX I - Article 26 of the MiFID implementing Directive ("Level 2 Directive")
CHAPTER III - OPERATING CONDITIONS FOR INVESTMENT FIRMS
Section1 - Inducements

Article 26
(Article 19 (1) of Directive 2004/39/EC) Inducements
Member states shall ensure that investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or ancillary service to the client, they pay or are in paid any fee or commission, or provide or are provided with any non-monetary benefit, other than the following:

(a) A fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;

(b) A fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

(i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service

(ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client;

(c) proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking.