

Mr. Steven Maijoor  
Chair  
European Securities and Markets Authority (ESMA)  
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France

Brussels, 7 December 2012

**Re: Consultation paper - Guidelines on remuneration policies and practices (MiFID)**

Dear Mr. Maijoor,

CFA Institute appreciates the opportunity to comment on the Consultation paper “Guidelines on remuneration policies and practices (MiFID)”.

We are a global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal is to create an environment where investors’ interests come first, markets function at their best, and economies grow. CFA Institute has more than 117,000 members in 139 countries and territories, including more than 108,000 Chartered Financial Analyst® charterholders, and 137 member societies. For more information, visit [www.cfainstitute.org](http://www.cfainstitute.org).

**Executive Summary**

CFA Institute global membership believes mis-selling of investment products by financial advisers remains a serious problem. In the Financial Market Integrity Outlook Survey that CFA Institute conducted in January 2011<sup>1</sup> among 98,079 of its members, mis-selling ranked as the number 1 issue both globally and in EMEA and more specifically “mis-selling of products by financial advisers” was considered by respondents as the most serious ethical issue facing their local markets. The Global Market Sentiment Survey 2012 (carried out in November 2011<sup>2</sup>) confirmed our members’ opinions in this regard.

CFA Institute therefore applauds ESMA’s efforts to sharpen the rules against mis-selling and to harmonise their implementation within the European Union. These efforts are crucial for the protection of retail investors, one of the key commitments of CFA Institute and its more

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<sup>1</sup> See [http://www.cfainstitute.org/Survey/financial\\_market\\_integrity\\_outlook\\_2011.pdf](http://www.cfainstitute.org/Survey/financial_market_integrity_outlook_2011.pdf).

<sup>2</sup> See [http://www.cfainstitute.org/ethics/Documents/global\\_market\\_sentiment\\_survey\\_report.pdf](http://www.cfainstitute.org/ethics/Documents/global_market_sentiment_survey_report.pdf)

than 107,000 members, which is reflected throughout the CFA Institute Code of Ethics and Standards of Professional Conduct<sup>3</sup>

New regulation of remuneration included in the Capital requirements Directive (CRD), the Alternative Investment Fund Managers Directive (AIFMD) and in the UCITS Directive (still under discussion) have a prudential focus and aim at discouraging excessive risk-taking, but do not address the crucial aspect of remuneration policies for staff providing client advice or portfolio management services at financial institutions.

Although MiFID contains the right principles to ensure investor protection, its implementation has clearly not brought sufficient change to market practices in financial product distribution. Mis-selling and insufficiently clear disclosure remain widespread, and enforcement by regulators in the Union has been unable to solve the problems. The focus on tighter regulation of inducements and better disclosure to clients (part of the MiFID II review) are welcome, but without other regulatory elements such as those covered by the present Guidelines, they are insufficient.

CFA Institute believes it is important for regulators to look at all business decisions that affect the distribution chain – from the payment of inducements by third parties to the choice of products by the firms, to the internal remuneration incentives for the sales staff.

We encourage ESMA and national regulators to seek effective client protection to help re-establish trust in financial institutions. Article 19 of the MiFID Directive states that “*Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients...*” In the Guidelines we repeatedly find language that only requires firms to ensure that clients’ interests are not impaired, or that incentives should not be created to the potential detriment of clients. While this is certainly necessary in view of the current situation in the distribution market, we would encourage ESMA to include more language that encourages firms not only to avoid clearly illegal behaviour, but also to structure themselves to fulfill all obligations towards their clients, including that of acting “*in accordance with the best interests of its clients*”. It should not be enough, therefore, to do the minimum to avoid damage to clients, but firms should actively work in their clients’ interest.

Simply avoiding remuneration structures that lead advisers to recommend clearly unsuitable products (mis-selling in its purest forms) for their clients still leaves several avenues for firms not to provide the best outcome for their clients. For example, advisers are still able to refrain from mentioning equivalent but cheaper investment products also sold by the firm (this is mentioned by ESMA in Example a3 in Annex I). They also are able to offer products only or

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<sup>3</sup> <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1>

primarily on the basis of their profitability to the firm, not their value to the client. This aspect is not addressed at all by ESMA in its Consultation Paper, and it does not seem that the Guidelines cover it. Nor is it covered directly by the remuneration policies already in force. While commercial freedom should be maintained, we consider that product selection – and the choice of products to highlight in marketing campaigns -- should also be scrutinized by regulators, as it also can lead to biased product offerings and poor outcomes for retail clients.

Lastly, as the Guidelines contain no enforcement recommendations to national competent authorities, we encourage ESMA to repeat its data gathering exercise to check whether remuneration policies and practices improve and how the Guidelines are enforced.

### Questions

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

Yes, we strongly agree. We also agree with ESMA that the first steps in conduct of business risk management should be effective avoidance and reduction of identified conflicts of interest, not disclosure to clients of unmanaged conflicts.

**2. 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.**

CFA Institute agrees. The remuneration incentives can vary widely depending on the type of organization, on the products, and on the position of the individuals, so the remuneration policies must take such variety into account.

**3. 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?**

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

Yes, we agree, though the view of what is the right balance will differ by firm, and from investor to investor. In some cases, we have found that investors and investment professionals are adamantly against variable remuneration because of the conflicts of interest

they may create. Others are inclined more toward advisers whose remuneration is based entirely on performance.

While an appropriate balance between the fixed and variable components of remuneration is very important, what is even more important is that the variable component be based above all on fulfilling client interests, not the firm's financial objectives. Moreover, the variable component of remuneration should be based entirely on positive client outcomes and client satisfaction.

**5. 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.**

As discussed in our reply to Q3 and Q4, fair treatment of clients, positive outcomes coherent with clients' investment goals, client retention and client satisfaction should be the criteria used for performance evaluation for remuneration purposes. If financial criteria (which ESMA equates to positive financial performance for the firms) are taken into account for the purpose of variable remuneration but are achieved at the expense of client satisfaction, the pressure on staff is likely to be too high and client interests will not come first.

Similarly to the prudential rules on remuneration introduced in CRD, AIFMD and UCITS Directive, the goal here should be to discourage short-term benefits to the firm staff that would hurt clients' interests in the long term. Client satisfaction should therefore be tested on an ongoing basis, not just shortly after the completion of a sale (Para. 72 of Consultation paper, among ESMA's examples of good practices).

**6. 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.**

Yes, CFA Institute agrees that senior management or, where appropriate, the supervisory function should approve remuneration policies and practices with input from the compliance function.

**7. 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.**

Yes, CFA Institute agrees. Senior management should bear responsibility for the implementation of remuneration policies and practices within the organization. Moreover, remuneration for senior management (especially the variable portion) also should be linked to

client outcomes, retention and satisfaction. In other words, senior management should not profit from positive financial results of a firm that does not fulfill its duties towards clients.

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

We agree, and we consider that any organizational measures taken to launch a new product or service must consider the potential risks to clients in light of existing remuneration policies and practices. Advice to clients must be suitable, and remuneration policies and practices should not reward unnecessary trading to earn commissions (not just churning) to the detriment of the client.

**9. 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.**

Yes, we agree. Such documentation should be a regular part of an adviser's efforts to ensure that product and services offered are suitable for clients. Supervisory enforcement, however, should not stop at a review of the internal documentation and compliance processes. Verification of advice provided to clients and "mystery shopping" checks should be conducted as well, to test the compliance of financial firms with their policies.

**10. 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.**

CFA Institute agrees. However, besides financial information regarding the firm's performance, qualitative data measuring client performance, satisfaction and retention should also be collected.

**11. 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.**

We strongly agree. The quality of the service should be one of the most important metrics in measuring performance for financial services' staff, as MiFID requires financial firms to act in accordance with the best interests of their clients.

**12. 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.**

Yes, we agree.

**13. 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?**

**14. 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.**

Yes, we agree. We would argue that it would be almost impossible for firms using remuneration practices that include a very high level of bonus progression or a very high percentage of variable remuneration to demonstrate compliance with the MiFID duty to act in the best interest of the client in all cases. Such remuneration incentives are likely to lead to non-compliance. Ideally, such remuneration policies should be subject to strict supervision and based solely on positive client outcomes and satisfaction.

### **Comments on Guidelines**

CFA Institute overwhelmingly supports ESMA's proposals, with the following exceptions.

We reiterate the fact that the Guidelines should focus more strongly on the firms' duty to act in the best interest of the clients, not just encourage firms to ensure that clients' interests are not impaired.

Para. 26 on page 36 - Examples of poor practice (second example): the products sold are inappropriate for the clients but a bonus is paid anyway, before the risks are identified. Due to the possibility of inappropriate, short-termist behaviour (particularly with remuneration policies creating the wrong incentives), it would be appropriate for regulators to require spreading the payment of incentives over a certain period of time, as well as claw-back clauses for inappropriate or illegal behaviour (for example, the provision of unsuitable advice).

We hope our comments will be of assistance to ESMA. Please do not hesitate to contact us should you wish to discuss any of the points raised:

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