

**Association for Financial Markets in Europe
International Capital Market Association
Futures and Options Association**

CESR CONSULTATION ON INDUCEMENTS: GOOD AND POOR PRACTICES

A joint response by the Association for Financial Markets in Europe (AFME), the International Capital Market Association (ICMA), and the Futures and Options Association (FOA)

Classifying 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?

Firms should be permitted to establish systems and controls that are proportionate to their business in order to monitor on an ongoing basis that they meet the inducement rules. There should be flexibility depending on the nature, scale and complexity of the business and the range of investment services and activities undertaken.

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?

Firms need to meet the requirements of the inducement rules, and should put in place compliance controls to monitor their compliance with the rules. It is also important to recognise that other control functions help to ensure that the firm is overall operating in compliant manner.

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 'inducements policy') should be approved by senior management?

We agree that the firm's general approach to compliance should be agreed with senior management, and all policies should be subject to a proportionate review and approval process within a firm. The specific arrangements for approval of the inducements policy should be for the firm to determine. Senior management's involvement should be proportionate to the nature, scale and complexity of the business and the nature of the range of investment services and activities undertaken in the course of that business, and it is not necessary for senior management to be involved in the detailed and specific compliance work.

Proper fees

Underwriting fees – Paragraph 48 differentiates between underwriting transactions where firms sell securities to investors and where they do not, and suggests that fees for the former would be generally subject to Article 26(b) but in the latter would

generally fall under Article 26(a). An underwriting transaction where a firm intentionally did not make any on-sales distribution (the latter scenario) would be in the nature of a large private proprietary trade, although such transactions are likely to be rare.

As a worked example of this issue, we set out below some background information on market workings relating to underwriting in the inter-institutional primary bond market, which we hope may help CESR members at national level in their consideration of the application of Article 26 in specific cases.

An underwriting fee is, despite its name, generally a combined remuneration paid by the issuer to the banks for arranging the underwriting and for an associated range of services provided directly in arranging the issue as well as for other services performed for the issuer as an issuer in the capital markets on continuing basis. It is typically paid as one total fixed fee (a percentage of the total amount of securities issued) and is not in practice broken down into parts corresponding to the various services provided.

Underwriting, in the literal sense, is a service provided to the issuer of securities. The basis of the inter-institutional primary bond market is that a financial institution or a syndicate of institutions (each an underwriter) will undertake to an issuer of securities that a specified number of securities issued by that issuer will be subscribed when issued. An underwriter will seek to find purchasers for the securities, but if it cannot do so it must buy them itself. The underwriting fee (or the relevant component of a combined fee) wholly relates to, and is a proper compensation for, an underwriter accepting this underwriting risk.

Where disclosure is required under Article 26(b), such disclosure presumably has the purpose of assisting the investor (i) in making its investment decision as to whether or not to use the underwriting firm's services in buying the securities being offered and (ii) to assess the extent to which the underwriter may be incentivised to sell that security rather than other comparable securities.¹

In an inter-institutional bond issue the investor's decision to buy a security is generally based solely on the issuer's credit rating and business and on the pricing and structure of the security by reference to a particular benchmark issue; so that the receipt by the underwriter of the underwriting fee will have no effect on the investor's investment decision and the investor will suffer no detriment if those fees are not disclosed to it. Unlike in the non-institutional market, in this market, securities are usually actively bought rather than being actively sold. Where it can be said that this is the case and that, on this basis, investors' decisions would not be influenced by disclosure of the fees paid to the underwriter by the issuer, it could be argued that disclosure would not serve a purpose on a purposive reading.

¹ In its May 2007 Recommendations on Inducements under MIFID, CESR stated, in paragraph 14, that the purpose of the disclosure regime is that it "puts regulatory controls around payments where there is the possibility of client detriment". It appears to follow from this that where there is no risk of client detriment, as in the case of the inter-institutional primary bond market, the MIFID inducements regime is not intended to apply. CESR's Recommendation 6(a) also supports this view, saying (in the context of a summary disclosure) that "disclosure must provide adequate information to enable the investor...to make an informed decision whether to proceed with the investment".

As noted above, a fee payable to the underwriter is normally composed of different elements. The total amount received by an underwriter from an issuer is likely to be regarded by both the issuer and the underwriter as a single composite payment, but there may be number of elements composing the payment - fees for underwriting, for management and a selling concession:

- if the underwriting fee (or underwriting component of a combined fee) wholly relates to, and is a proper compensation for, the underwriter accepting underwriting risk, the underwriter will be paid by the issuer for a service provided to it;
- arguably, although the management fee (or management component of a combined fee) may not relate to the underwriting service, it relates to other services provided by the underwriter to the issuer which are specific to the issue, such as the underwriter's involvement in documenting the issue; these are not services in relation to which the underwriter provides investment services to investors (if it provides any investment services to the investors at all);
- any selling concession would be at a discount from the price at which the underwriter subscribes the securities and normally disclosed to the market.

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)?*

Yes. Also, where firms need to use an external broker in order to execute client orders due to local restrictions or operational reasons, arguably the payments should also fall under the definition of a proper fee because they are necessary for the execution of the client's orders and are akin to exchange fees, except that the fees in this case are paid to third party brokers.

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?*

Tax sales credits should generally be eligible for the proper fees regime, for the reasons that CESR cites. They meet all the requirements of the MIFID provisions, in that they "enable or are necessary for the provision of designated investment business or ancillary services, and, 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."

TSCs are typically paid by firms engaged in cross-border agency sales activity. For tax and company law purposes, firms must ensure that income is correctly recognised in the jurisdiction which incurs the cost of the sales function. The appropriateness of the methodology from a tax perspective would be agreed by each firm on a bilateral basis with the relevant tax authority and would be regularly assessed. Tax Sales Credits calculated on parameters set by the authorities do not influence the behaviour of sales staff, and do not conflict with the firm's duties towards its clients. Such payments should therefore fall under the proper fees definition.

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 service 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?

We would argue that as long as a payment is designed to provide a benefit to clients, it does not matter whether the payment is one-off or over a period of time. Such arrangements should be allowed if they meet the test of adequate disclosure to enable the client to make an informed decision about the arrangement.

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?

We agree that an effective compliance function should be backed up with appropriate monitoring and controls to deal with all potential conflicts arising from the firm's business. See also our answers to QI and QII above.

Question IX: What are your comments on 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 agree. We may provide CESR with other examples in a later supplement to this response.

Question X: What are your comments on 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?

The relevant consideration should be whether a payment is indeed designed to enhance the quality of the service (including enabling the service to be provided at all) rather than whether or not they cover costs that would have been charged to the client.

Payments and non-monetary benefits authorised subject 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)?

According to Article 26(b), a firm receiving or paying a fee qualifying as an inducement must disclose to the client the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, in a manner that is comprehensive, accurate and understandable, *before the provision of the service.*

Securities are typically offered in the inter-institutional primary bond markets immediately when the issue is launched. As order books will often be opened before the prospectus or final terms for the issue are available, these documents will not always provide an appropriate method for any disclosure of fees to investors, and any required disclosure would have to be made to each investor when it is first contacted in relation to the issue, whether by being included in an existing document (such as a termsheet) sent to the investor at that time or in some other way. The only available means for disclosing the fees would be post-transaction disclosure. In some cases, issuers may even choose to award discretionary fees once they have assessed a transaction's performance – that is following its completion.

The need to provide a summary or full details (upon a client request) of underwriting payments should depend upon the nature of the issue and the classification of the client. Given that the purpose of the disclosure requirements is to ensure that no client is disadvantaged by non-disclosure or a potential conflict of interest, greater care needs to be taken where there is retail client involvement. Where an issue is intended for institutional clients that would generally be aware of the costs of underwriting and commission and where the third party costs will not affect their decision to invest, disclosure may be less necessary, and in some cases may be detrimental if it releases information that benefits competitors. However where the services being provided are intended for retail clients who are not aware of the broad terms for such services it is reasonable to expect a summarised disclosure of terms.

Where a fee or commission is linked in any way to the success of the deal a clear disclosure of the third party payments should be included within the issued documentation. In all such cases disclosure should be fair, clear and not misleading; and full details available upon request.

The examples above illustrate that as a general rule, where the quantum of a disclosable inducement is known, it should be disclosed. If the quantum is not known, but can be explained in terms of the calculation mechanism, that is the appropriate disclosure. Where neither the quantum nor the method is known, generic disclosure is appropriate, pending the availability of more information.

Question XII: What are your comments on CESR's views about detailed disclosures?

See our comments under QXI above.

Question XIII: Do you have any comments on CESR's views on the use of bands?

We support the use of bands as a practical alternative to disclosing the actual fee amount provided the the bands are set at an appropriate level.

There may be situations whereby exact fees cannot be disclosed before each trade. For example for some flow trades there may be very little time before each trade to enable specific fee disclosure be made. In these cases a more practical approach would be to disclose in advance a fee band or a description of the method of fee calculation, and provide further details to clients upon request.

In the context of CESR's statement that a band should not be stated as having a 0% minimum if in fact the minimum is, say, 20%, it is important to be aware that in wholesale markets in certain circumstances it may be difficult to establish a precise minimum level, even though professional clients will understand that the fee is likely to be close to the maximum fee quoted.

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

Generally we agree, but there should be differentiation of approach between retail and professional clients. While for retail we agree that to the extent possible disclosures should be in easily accessible consolidated documentation, for professionals there should be more flexibility. It is most important that disclosures should be fair, clear and not misleading, but less important to stipulate what form of publication should display the disclosure.

Summary disclosure is not always possible in the initial client information pack because fee levels are sometimes deal specific. In these cases any disclosure would be so general that it does not provide much value to clients. Firms should have the flexibility to disclose fees to clients using the most appropriate medium.

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

We agree that professional clients have the knowledge and experience to make their own investment decisions, and that it is legitimate for investment firms to take this into account in the drafting of summary and detailed disclosures under the MiFID inducements rules: the level of disclosure should take into account the client's sophistication.

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