THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/06-687

# Inducements under MiFID

Public consultation

December 2006

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CONTENTS

## Introduction

Article 19(1) of the Level 1 Markets in Financial Instruments Directive 2004/39/EC ("MiFID") provides that when providing investment services and/or, where appropriate, ancillary services to clients an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients. Article 26 of the Level 2 Implementing Directive 2006/73/EC (entitled "Inducements") sets further requirements in relation to the receipt or payment by an investment firm of a fee, commission or non-monetary benefit.

CESR is considering issuing a recommendation to its members setting out a common approach to the operation of Article 26 of the Level 2 Directive. This consultation paper presents proposals and questions which will assist it in developing that recommendation. Consulting in this way will help to ensure that the views of the industry and consumers can be fully taken into consideration.

The consultation paper:

- Provides a general explanation of Article 26 and identifies inducements as a source of conflicts of interest.
- Discusses the circumstances in which a fee or other benefit will be considered to be paid or provided to or by the client or a person acting on behalf of the client.
- Discusses the application of the conditions that third party receipts and payments must meet in order not to be prohibited, illustrating the concepts with a number of examples.
- Discusses some issues to do with disclosure.
- Discusses the position of tied agents under Article 26.
- Asks for respondents' views on the application of Article 26 to softing and bundling arrangements.

Preparation of these guidelines is being undertaken by the MiFID level 3 Expert Group. The Group is chaired by Mr Arthur Philippe, Director of Luxembourg's Commission de Surveillance du Secteur Financier (CSSF) and Mr Antonio Carrascosa Morales, General Director of Spain's Comisión Nacional del Mercado de Valores and Chairman of the MiFID Level 3 intermediaries' subgroup.

### Public Consultation and Timetable

CESR invites responses to this consultation paper. Respondents can post their comments directly on CESR's website (www.cesr.eu) in the section "Consultations". The consultation closes on **9 February 2007**.

The purpose of this consultation is to receive responses to the contents of this document and to the specific questions it contains. CESR has included these questions to highlight those areas in which it would be particularly helpful to have the views of respondents. Respondents are also welcome to make any relevant points which they do not think are covered directly by the questions.

## General explanation and relationship with conflicts of interest

1. MiFID refers to inducements in both Articles 21 and 26 of the Commission Directive 2006/73/EC. Article 21 sets out minimum criteria that a firm must take into account in identifying relevant types of conflict of interest. In doing so it establishes as one of the criteria[1] (e) that the firm (or a relevant person or a person linked directly or indirectly by control to the firm) receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service. It is clear from this that an inducement that is received by a firm can create a potential conflict of interest. MiFID requires a firm to manage such conflicts of interest.

2. Article 26 operates differently. It sets conditions that must be met in order for a fee, commission or non-monetary benefit not to be prohibited. In doing so, it applies to all fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client. It does not deal with payments made within the investment firm, such as internal bonus programmes, even though these could constitute a conflict of interest covered by Article 21. It should be appreciated, therefore, that Article 26 is of very wide application to payments made to and by investment firms. For example, in contrast to Article 21, it appears to CESR that Article 26 also applies to a "standard commission or fee" that may be paid or provided to or by an investment firm.

3. Article 26 applies only to items received or provided by an investment firm, whereas through the concept of "relevant persons" the rules on conflicts of interest also apply to individuals working for the investment firm. This does not mean that a payment or receipt is outside article 26 merely because it is paid or provided to or by an employee of an investment firm. Many items of this type, but not all cases, can also properly be considered as a payment or receipt by or to the investment firm in connection with an investment or ancillary service provided to a client.

4. There are two general circumstances, both considered at greater length within this paper, in which Article 26 does not prohibit a firm from paying or receiving fees, commissions or non-monetary benefits. These are:
   - In Article 26(a) that the item is paid or provided to or by the client or a person acting on behalf of the client;
   - In Article 26(c) that the item is a "proper fee" that enables or is necessary for the provision of investment services.[2]

5. Some commentators have suggested that Article 26 (c) has wide application so that the other elements of Article 26 of the Level 2 Directive should be treated as applying only to payments or receipts that in some way or other are made with the purpose or intent to influence the actions of a firm. The main reason for believing this is a wide interpretation of "proper fee" so that a very wide range of receipts or payments is not subject to the prohibition.

[1] Extracts from Articles 21 and Article 26 of the Level 2 Implementing Directive are provided within Annex A to this paper.

[2] Article 26(c) of the MiFID Level 2 Implementing Directive sets out that "proper fees" are those that "*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*".

6. CESR does not believe that such an interpretation is correct. Within Article 26(c), although the list of items it mentions cannot be exhaustive (and, therefore other cases will be relevant) the types of payment or receipt that it refers to must be proper fees which "enable or are necessary for the provision of investment services" 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". But, it is clear that the possibility of a receipt of a standard commission or fee can act as an incentive for an investment firm to act other than in the best interests of its client. So, in CESR's view any items that are not of a type similar to the costs it mentions - custody costs, settlement and exchange fees, regulatory levies or legal fees – are unlikely to fall within this exception.

7. Fees and other benefits that are paid or provided to or by a third party and not the client but which are not "proper fees are dealt with under Article 26 (b). Unlike payments to and receipts from clients these have to meet a number of conditions in order not to be prohibited. These are:

   - there must be clear, prior disclosure to the firm's client; and,
   - the item must be designed to enhance the quality of the service to the client and it must not impair compliance with the firm's duty to act in the best interests of the client.

8. The flowcharts in Annexes B and C show how the various conditions fit together.

9. We can see now how this relates to Article 21 of the Level 2 Directive. In principle a payment to a third party or a receipt from a third party in relation to a service provided to a client could put the investment firm in breach of its duty to act in the best interests of the client. So, such a receipt or payment creates a potential conflict of interest between the investment firm and its client. MiFID, through Article 21 of the Level 2 Directive, requires an investment firm to manage such conflicts so that the risks of damage to the interests of clients are minimised. It is only if what the investment firm does is successful in ensuring that the payment or receipt does not impair compliance with the investment firm's duty to act in the best interests of the client (and the other two tests set out above are also met) that the payment or receipt will not be prohibited under Article 26.

10. Of course, other MiFID requirements will also be relevant and must be met, for example duties under Article 19(3) of the MiFID Level 1 Directive (2004/39/EC) to provide appropriate information to clients or potential clients. Such requirements are not further discussed within this paper.

*Question 1: Do you agree with CESR that Article 26 applies to all and any fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client?*

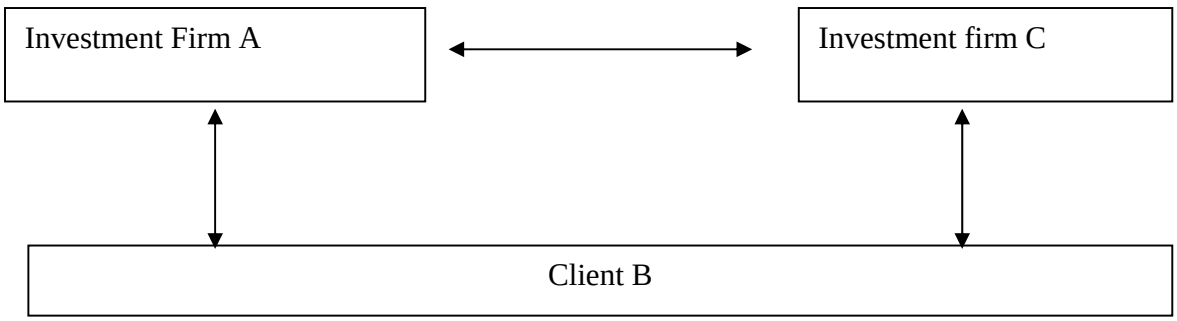
*Question 2: Do you agree with our analysis of the general operation of Article 26 of the MiFID Level 2 Implementing Directive and of its interaction with Article 21?*

## Article 26 (a): items "provided to or by the client"

11. Article 26(a) provides for circumstances in which an investment firm is not prohibited from paying or receiving fees, commissions or non-monetary benefits in relation to an investment or ancillary service provided to a client. The circumstances are where the item is a "*fee, commission or non-monetary benefit paid or provided to or by the client or a person acting on behalf of the client*".

12. This is in CESR's view fairly straightforward and applies in fairly restricted circumstances. Examples will be where the client pays a firm's invoice directly or it is paid by an independent third party, such as an accountant or lawyer, acting on behalf of the client. In such cases the "person acting on behalf of the client" is acting as a mere conduit for the payment or receipt acting on the instructions of the client. Other examples include circumstances where there is no contractual relationship with respect to the provision of the investment service between the person who acts as conduit and the Investment Firm that receives the payment.

13. Article 26(a) may also be relevant in limited other circumstances. For example, suppose an investment firm (A) provides to its client (B) the services of investment advice and/or reception and transmission of orders. As a result of the investment advice A who transmits an order to investment firm C where the client has his account. Investment firm C will execute the order of the client. After executing the order the investment firm C sends a confirmation note to the client and to the investment firm A.




14. Suppose also that the client has agreed with investment firm A the fee that he will pay to A. The client could, if he wished, also provide explicit instruction to C that out of the client's account with C should be paid the amounts that the client owes to investment firm A. C would report these payments out of the account as separate items from C's own charges. Here it is clear that C is acting on behalf of its client and the arrangements are within Article 26 (a), and, that C is not a "third party" such as to require the tests of Article 26(b) to be met.

15. These examples demonstrate the limited circumstances in which Article 26(a) is relevant and make it clear that for Article 26(a) to apply it is clearly not sufficient that the cost of a fee, commission or non-monetary benefit is borne by the client. Circumstances in which a product provider pays a share of commission to an investment firm will, in CESR's view, always, or almost always, be dealt with under Article 26(b), which is dealt with in the next section.

*Question 3: Do you agree with CESR's view of the circumstances in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by … a person acting on behalf of the client"?*

*Question 4: What, if any, other circumstances do you consider there are in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by the client or a person acting on behalf of the client"?*

**Article 26(b): conditions on third party receipts and payments**

16. Items that are not "proper fees" that are paid to the investment firm by a third party (or which the investment firm pays to a third party) and not the client are dealt with under Article 26 (b). Unlike payments to and receipts from clients these have to meet a number of conditions in order not to be prohibited. These are:
    - the item must be designed to enhance the quality of the relevant service to the client and it must not impair compliance with the firm's duty to act in the best interests of the client; and
    - there must be clear, prior disclosure to the firm's client (see following section).

17. These tests appear to be primarily concerned with circumstances in which the client of an investment firm will bear the cost of the payment or receipt of a monetary or non-monetary benefit to or by an investment firm, but which may also result in some benefit to the investment firm. Sometimes the client will bear the costs directly and sometimes indirectly. It is reasonable therefore for there to be a requirement for the client to benefit as a result of the payment.

18. If the investment firm makes a payment to a third party in relation to a service provided to a client then the client is likely to bear the cost – either directly, because the client is recharged, or, because the investment firm's own fees are higher in order to offset the cost. Similarly, if the investment firm receives from a third party money or goods or services, then, if these are received in relation to a service provided to the investment firm's client, the client (or, clients more generally) will likely bear the cost. For example, if the investment firm arranges services such as custody for the client (and passes on costs to the client) then the provision of a benefit by the custody provider to the investment firm is likely to result in higher costs for the client.

19. Some commentators have questioned the term "designed to enhance the quality of the relevant service to the client". This test makes clear that a permitted item must relate to the service provided to the client, and not to some other service; and, there must be benefit to the client in relation to that service, and, not just to the investment firm or to other clients. The words "designed to" also help to make clear that a judgement about a fee or payment can be made at the time it is proposed it will be paid or received, rather than only once it has been made. However, this does not impair the possibility for competent authorities to review inducements that have not been prohibited *a priori* on the basis of the effective use that is made of them both in general or by a given firm.

20. Even where a payment or receipt is designed to enhance the quality of the service to the client, for it to be permitted it is necessary for it also to meet the condition that it not impair the firm's compliance with its duty to act in the best interests of the client. This includes the firm's general duty as well as specific duties imposed by particular requirements of MiFID.

21. In many cases it is difficult to consider the payment or receipt of a fee, commission or other benefit in isolation. It will be necessary to consider the circumstances in which the item will be paid or provided and other factors such as the conditions that attach to it.

22. Recital 39 of the Directive 2006/73/EC refers to situations where investment firms are paid by commissions received from product providers (such as, by the management company of a collective investment scheme). CESR's view is that recital 39 makes clear that such a type of remuneration can be legitimate, provided that the investment firm's advice or general recommendation to its client is not biased as a result of the receipt of that commission. If this condition is met then the advice or recommendation should be considered as having met the condition of being designed to enhance the quality of the service to the client. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interest of the client – must also, of course, be met. Therefore, not all commissions of this type in all circumstances will be permitted under Article 26. For example, a commission which gives disproportionate benefit to the firm relative to the value of the service provided to the client is likely to impair the firm's compliance with its duty to act in the best interests of the client.

23. Recital 39 refers to an investment firm that is giving unbiased investment advice or general recommendations. This recital is not the only provision that informs the application of Article 26 of the Level 2 Directive, and does not determine other cases. CESR's view is that it is not the intention of MiFID and its provisions about inducements altogether to prohibit other distribution arrangements where an issuer or product provider pays an investment firm for distribution. The conditions of Article 26 (b) – including the disclosure requirement – must, of course, be met. This does not mean that all possible models under which there is remuneration for distribution will be acceptable.

    This "*a priori*" assessment of payments for distribution does not necessarily mean that all these payments could not become contrary to the MiFID if an improper use is made of them so that the firm effectively acts contrary to the best interest of its clients or delivers biaised advice. Firms should be aware of the fact that Article 26 conditions are as much related to the design and objectives of the payment as to the use that effectively is made of them.

24. In order to explain how Article 26(b) operates CESR has therefore considered a number of examples. These illustrate some of the variety of circumstances in which Article 26 is relevant. In some cases, for example where the investment firm is providing the services of investment advice or portfolio management to its client it has more responsibilities to its client than in others. In such cases the level of remuneration, the conditions attaching to it, the circumstances in which it is paid or received and the extent to which the investment firm will benefit in relation to the client are all highly relevant to the tests under Article 26 (b).

25. The examples CESR has considered are set out below.

    **Example 1.** An investment firm gives investment advice to a client to buy a particular collective investment scheme and receives a commission from the management company paid out of the product charges made to the investment firm's client.

    As discussed above, Recital 39 makes clear that the receipt of such commission in circumstances where the advice or recommendation is not biased should be considered as designed to enhance the quality of the investment advice. But, the other conditions of Article 26 (b) will also have to be met, and, if the commission is disproportionate to the market then it is more likely the commission payment will impair the investment firm's duty to act in the best interests of its client. In CESR's view this does not mean there should be any cap on the level of commission that may be received by an investment firm – after

all, the services that the investment firm provides could be extensive or the quality of its service very high. However, to be legitimate any such commission must meet the tests within Article 26(b), in particular that it not impair compliance with the duty to act in the best interests of the client. The benefit to the firm in relation to the benefits provided to the client will be one indicator, amongst others, that will allow a judgement to be made.

**Example 2.** An investment firm that is not providing investment advice or general recommendations has a distribution agreement with a product provider, such as the management company of a UCITS, to distribute its products in return for commission.

The investment firm will provide its clients with information about the offer, collect in applications from the clients and pass them on to the management company, but will not owe a duty of suitability to its clients. As discussed above, CESR's view is that it is not the intention of MiFID altogether to prohibit such arrangements in which the product provider pays a fee to an investment firm.

Although the condition of being designed to enhance the quality of the service to the client may be considered to be met, the other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty to act in the best interests of the client – must also, of course be met. Therefore, not all commissions of this type in all circumstances will be permitted under Article 26. For example, a commission which is disproportionate to the value of the service provided to the client is likely to impair the firm's compliance with its duty to act in the best interests of the client.

**Example 3.** An investment firm acts as portfolio manager (or as a receiver and transmitter of orders) and transmits orders to brokers for execution. It charges a management fee (or a fee for the reception and transmission of orders) to its clients and has existing charging arrangements in place between itself and brokers and its clients for commissions to be charged to its clients.

Suppose one of the brokers that the investment firm uses offers to pay the investment firm an additional sum of money based on the orders it receives from the investment firm. The amount to be paid by the broker may be based on the number of orders, the number of instruments to be purchased or sold in accordance with the orders, or the value of the orders. There is no condition that the money be repaid to the clients of the investment firm.

The arrangement entered into by the investment firm does not appear to provide any new benefit for the clients of the investment firm. The investment firm itself receives a benefit and therefore has an incentive to use only the broker offering the payments. Any enhancement of the service provided to the investment firm's clients seems unlikely, but the incentive is likely to impair the firm's duty to act in the best interest of its clients (for example, to provide best execution).

**Example 4.** A management company of a UCITS provides training to the staff of an investment adviser that is an investment firm.

For the purpose of this example, we suppose that the investment firm provides the service of reception and transmission of orders and/or investment advice and that the training is about new types of product that are being made available in the market. In such a case it is possible that the training will have been designed to enhance the quality of the service provided by the investment firm, but only if there is a close link with the service provided by the investment firm. If the training is provided on the premises of the investment firm then it is possible that the benefit provided to the firm will not be disproportionate in relation to the benefit to the client, so that it will not impair the investment firm's compliance with the duty to act in the best interests of the client. So, it is possible that

some items of this nature would be permitted. Investment firms that receive such items must of course disclose them under Article 26 (b) (i).

If the same training is provided in an exotic holiday location paid for by the UCITS management company then it is more likely that it will impair the investment firm's compliance with the duty to act in the best interests of its client. So, the item would not be permitted in such cases.

**Example 5.** An investment firm G introduces one of its clients to another investment firm F. There is an agreement between F and G that F will pay to G a share of dealing commission or management fees to G, even though G will have no continuing role in F's relationship with the client.

In this case G has properly advised the client about the type of service he requires and has identified and introduced him to an investment firm able to provide that service. Under the arrangements G would receive a one-off payment or periodic or recurrent payments from F. CESR's view is that such an arrangement is not altogether prohibited. However, not all levels of payments will be able to meet the test of not impairing compliance with the duty to act in the best interests of the client, in particular if the firm F is not likely to enhance the quality of the service to the client. Article 26 also requires disclosure of the arrangement.

**Example 6.** As example 1, except the investment firm receives a one-off bonus (or "override") payment under the sole condition that sales of a particular product reach an agreed level.

Such an arrangement appears unlikely to be designed to enhance the quality of the service to the firm's client. Further, as sales approach the target level it becomes more likely that the firm's advice will become biased towards that particular product, in breach of the duty to act in the best interests of clients.

**Example 7.** A broker provides to an investment manager general office equipment such as computer equipment.

Our analysis is that a case could be made that this item will enhance the quality of the service provided to the client of the investment manager. But, this seems only peripheral to the general benefit that would be provided to the investment manager. It seems unlikely that the provision of the benefit could be designed to enhance the quality of the service provided by the investment firm to its client.

The purpose of providing the equipment and the likely effect of providing it appear to be to induce the investment manager to trade with that broker in preference to other brokers. That would impair the firm's compliance with its duty to act in the best interests of the client. This suggests it could be a breach of Article 26 for the investment firm to accept the equipment.

**Example 8.** An investment firm provides a portfolio management service to a client and charges a fee for that service. The investment firm purchases UCITS for the client; the management company of the UCITS pays a commission to the investment firm that is paid out of the product charges made to the client.

The receipt of commission in addition to the management fees received for the service of portfolio management is of a nature that could impair the firm's duty to act in the best interests of its client and it has to be established in each case that it would be designed to enhance the quality of the service to the client. One option therefore is for the investment firm to repay to its client any commissions received. In exceptional cases, however, it may

be possible for a firm to demonstrate that the conditions within Article 26, including the disclosure requirement, are met.

26. In CESR's view the examples above assist in determining factors that are relevant to the question whether or not an item will be treated as designed to enhance the quality of a service to the client and not impair the duty to act in the best interests of the client. The factors include:

(i) The nature of the investment or ancillary service provided by the investment firm to the client, including whether the investment firm is acting as agent for its client, and any specific duties it owes to the client in addition to those under Article 26.

(ii) The nature and extent of the benefit that the client will receive.

(iii) Any benefit that the investment firm receives and the extent to which it is proportionate to the benefit receivable by the client.

(iv) How the investment firm's behaviour might change as result of the receipt or provision.

(v) Whether there will be a greater or lesser incentive for the investment firm to act in the best interests of the client.

(vi) The circumstances in which the item is paid or provided and any conditions attaching to it. This seems to be particularly relevant where non-monetary benefits are provided.

*Question 5: Do you have any comments on the CESR analysis of the conditions on third party receipts and payments?*

*Question 6: Do you have any comments on the factors that CESR considers relevant to the question whether or not an item will be treated as designed to enhance the quality of a service to the client and not impair the duty to act in the best interests of the client? Do you have any suggestions for further factors?*

## Article 26(b): disclosure

27. Article 26(b) recognises prior disclosure to the firm's client as one of the conditions for receipts or payments paid or provided to or by a third party to be permitted.

28. As far as the content of the disclosure is concerned, Article 26 (b) (i) is clear in setting out the information that an investment firm should provide, that is: "*the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount".*

29. The final paragraph of Article 26, however, allows for an investment firm to provide summary disclosure ("*the essential terms of the arrangements … in summary form*") rather than the full information:

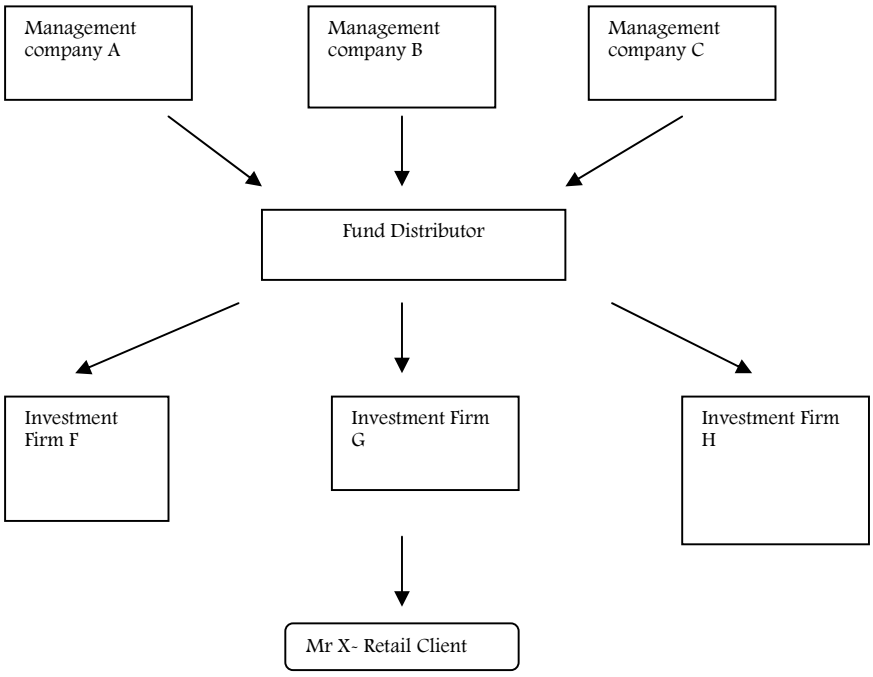
> *Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided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

30. A generic disclosure which refers merely to the possibility that the firm might receive inducements is not in CESR's view sufficient to enable the investor to make an informed decision and therefore will not be considered as meeting the requirements of Article 26. In CESR's view such a summary disclosure must provide sufficient and adequate information to enable the investor to make an informed decision whether to proceed with the investment or ancillary service and, whether to ask for the full information. In particular the investor must be able to relate the disclosure to the particular investment or ancillary service that is provided to him, or, products to which it relates. Without information of that type it would not be possible for the client to assess the suitability for him of the proposed investment or ancillary service.

31. It might be thought useful for CESR to provide guidance on the exact content of this summary. Such guidance would have to be suitable for all investment firms in all relevant businesses in relation to all clients. It would also have to be suitable in relation to all types of arrangements. CESR doubts that it would be useful to try to develop this guidance. It would be a formidable task to set out to perform. It seems unlikely that all circumstances and situations could be covered, so firms might suffer costs in excess of the benefits that would be brought by such an approach; and, it is likely that the work would become out of date and incomplete very quickly.

32. As to the particular items that must be disclosed, CESR believes that when between a product provider (such as the management company of a collective investment scheme) and the final client there is a distribution channel with at least one further intermediary, all of the investment firms along the distribution channel must respond to the obligation of an investment firm to act in the best interest of its clients. But, the items that Article 26 requires to be disclosed in relation to the final client are those received by or provided by the last intermediary in the chain – that is, the investment firm that is providing the service to that client.

33. We can see this through an example of a type of structure set out below.




34. We have to determine which of the relationships fall under Article 26 of the implementing directive 2006/73/EC. Mr X is the end-client and is a client of Investment Firm G. It is the relationship with Mr X that is relevant in relation to Article 26, that is, the fees, commissions and non-monetary benefits received by or provided to Investment Firm G in relation to the investment or ancillary service provided to its client, Mr X. In the case of permitted items, these should be disclosed to Mr X.

35. There could be fees, commissions and non-monetary benefits (in the nature of inducements) between Management companies and the Fund distributor, and between the Fund distributor and Investment Firms. CESR considers that the arrangements that need to be considered and, where relevant, disclosed by Investment Firm G are those that can influence or induce Investment firm G, which has the direct relationship with the client.

36. Under some arrangements Mr X will be the client of more than one investment firm. If that is the case, then each of those firms must ensure that it satisfies Article 26 in respect of Mr X.

37. It is possible an investment firm might try to avoid Article 26 through artificial means such as directing payments to a subsidiary (or, outside the group altogether). In this context, however, the provisions in respect of conflicts of interest and the duty to act in the best interests of the client remain relevant. These would have the effect of prohibiting such arrangements or of ensuring that the investment firm discloses the amounts to the client.

*Question 7: Do you agree that it would not be useful for CESR to seek to develop guidance on the detailed content of the summary disclosures beyond stating that:*

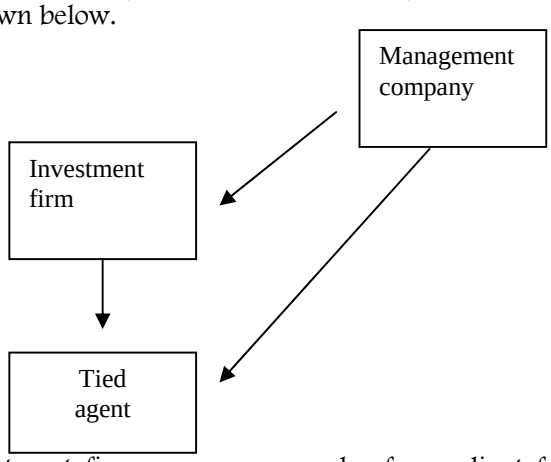
*such a summary disclosure must provide sufficient and adequate information to enable the investor to make an informed decision whether to proceed with the investment or ancillary service; and, that*

*a generic disclosure which refers merely to the possibility that the firm might receive inducements will not be considered as enough?*

*Question 8: Do you agree with CESR's approach that when a number of entities are involved in the distribution channel, Article 26 applies in relation to fees, commissions and non-monetary benefits that can influence or induce the intermediary that has the direct relationship with the client?*

## Tied agents

38. Article 23 of the MiFID Level 1 Directive allows investment firms to appoint tied agents for the purpose of promoting the services of the investment firm, soliciting business, receiving and transmitting orders, placing financial instruments and providing advice in respect of the financial instruments and services offered by the investment firm. The investment firm remains fully and unconditionally responsible for any action or omission on the part of the tied agent when it is acting on behalf of the firm. Article 26 of the MiFID Level 2 Directive does not refer to tied agents, so it is necessary to determine how they are treated under hat Article. A common situation is shown below.




39. Suppose a tied agent of the investment firm arranges an order for a client for a UCITS operated by the management company. A number of arrangements are possible. It is possible for the management company to pay commission of say €x to the investment firm which then passes on a lower amount €(x-y) to the tied agent. There is need to determine which of the amounts should be taken into account when considering the tests within Article 26(2) (b) of the Level 2 Directive.

40. In CESR's view it is the higher amount €x that is relevant to Article 26(2)(b). Where relevant, this is the amount that is required to be disclosed to the client (a single disclosure is enough). This is because the investment firm is unconditionally responsible for the actions of the tied agent and therefore €x is the total amount that is considered to be received by the investment firm.

*Question 9: Do you have any comments on CESR's analysis of how payments between an investment firm and a tied agent should be taken into account under Article 26 of the Level 2 Directive?*

*Question 10: Are there are any other issues in relation to Article 26 and tied agents that it would be helpful for CESR to consider?*

## Softing and bundling arrangements

41. Under softing and bundling arrangements, goods and services are supplied to a portfolio manager in return for business put through a broker. The broker's commission charges – which are passed through to the portfolio manager's customers – are higher in order to offset these goods and services supplied ('softed') to the portfolio manager. The commission charges are said to be 'bundled' because the broker charges a single commission to cover the broking services he supplies together with the softed goods and services. It is possible therefore for goods and services to be 'softed' without commission charges being 'bundled' - for example, if there is separate disclosure of and assent to specified charges for 'the softed services.

42. Investment managers have incentives to trade through brokers with whom they have soft commission arrangements. This is because they have the convenience of not having themselves to source the softed services and hence lower administration costs and their clients pay (through higher commission charges) for some goods and services they would otherwise have to pay for out of profits or negotiate separate repayment with clients. Such arrangements could lead to overtrading (to gain commission credits to buy new services), poorer execution than otherwise, and to the over-consumption of non-execution services such as investment research and data services, which would result in higher costs for investors. Where the brokerage arrangements are also bundled there is no transparency over the costs of the soft commission arrangements and therefore limited opportunity for the investment manager to ensure value for money, which again is likely to result in higher costs for investors.

43. Similar arrangements may also exist between an investment firm that receives and transmits orders and a broker responsible for executing them.

44. Such arrangements are common but regulated differently by different Member States. CESR intends to carry out a programme of work so that it can understand whether it is necessary to have a common approach across the EU to the supervision of these arrangements and, if appropriate, develop an appropriate common approach. To inform that work it would be helpful to have responses to some preliminary questions.

*Question 11: What will be the impact of Article 26 of the MiFID Level 2 Directive on current softing and bundling arrangements?*

*Question 12: Would it be helpful for there to be a common supervisory approach across the EU to softing and bundling arrangements?*

*Question 13: Would it be helpful for CESR to develop that common approach?*

## Annex A: Extracts from MiFID Implementing Directive 2006/73/EC

*Recitals 39 and 40*

*(39) For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client.*

*(40) This Directive permits investment firms to give or receive certain inducements only subject to specific conditions, and provided they are disclosed to the client, or are given to or by the client or a person on behalf of the client.*

*Article 21:*

*Member States shall ensure, for the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, investment firms take into account, by way of minimum criteria, the question of whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise:*
*(…)*
*(e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies goods or services, other than the standard commission or fee for that service.*

Article 26:

*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 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 acting 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;*

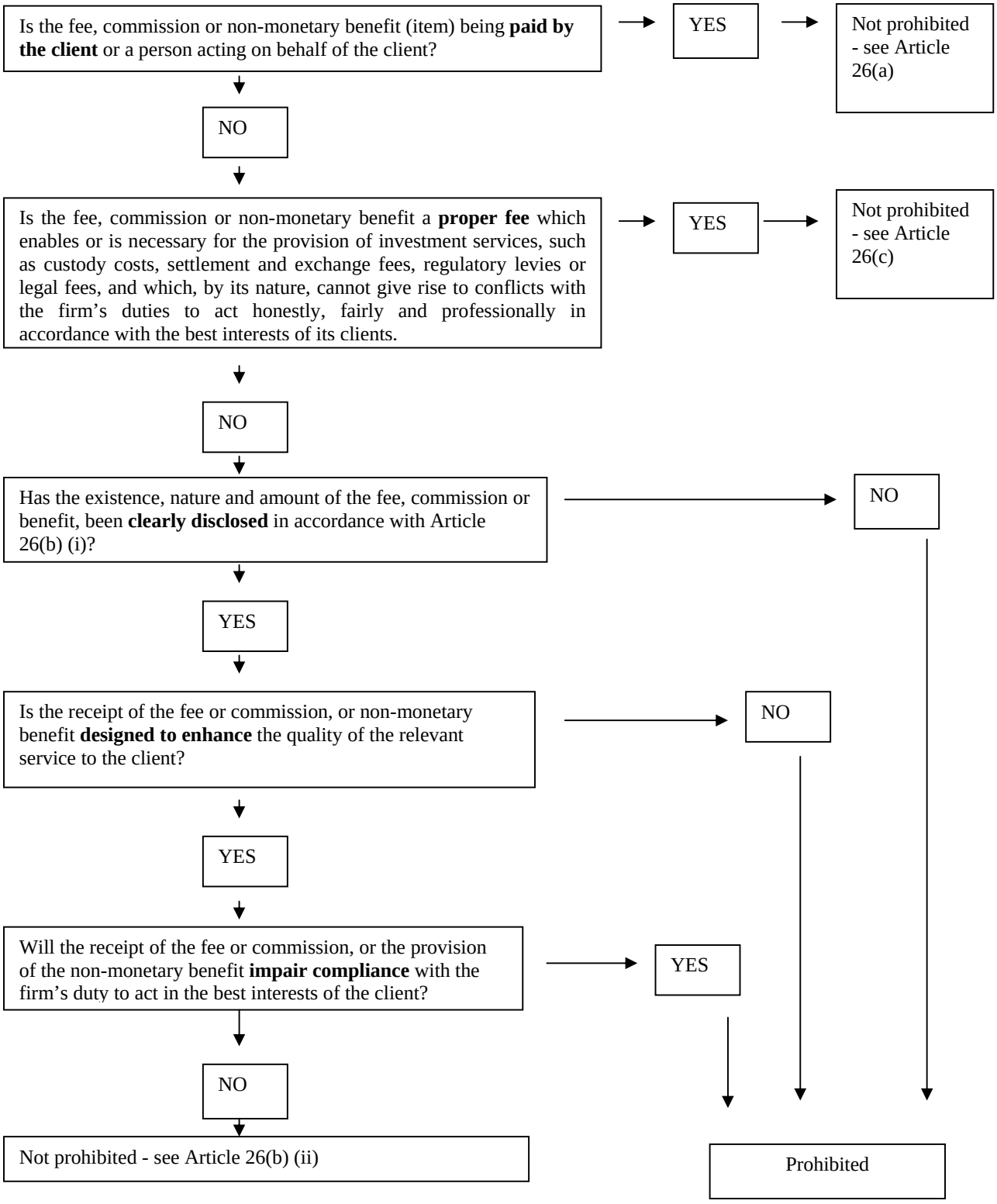
*(ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.*

*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".*

**Annex B**
**To show the treatment under Article 26 of a fee, commission or non-monetary benefit *received by* a firm in connection with a service provided to its client**



**Annex C**
**To show the treatment under Article 26 of a fee, commission or non-monetary benefit *paid by* a firm in connection with a service provided to its client**