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Mr. Fabrice Demarigny
Secretary General
Committee of European Securities Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

Paris, 5 February, 2007

AFG RESPONSE TO CESR'S CONSULTATION ON INDUCEMENTS UNDER MIFID

Dear Mr Demarigny,

The Association Française de la Gestion financière (AFG)[1] welcomes the CESR's consultation on inducements under MiFID, in the context of CESR's work on MiFID Level 3. Beyond our response, we also support the separate answer provided by our European Association, EFAMA[2].

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include almost 400 management companies and more than 700 investment companies. They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management (making in particular the French industry the leader in Europe in terms of financial management location for collective investments, with nearly 1500 billion euros, i.e. 22% of all EU investment funds assets under management, and the second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds and a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA).

[2] EFAMA is the European Fund and Asset Management Association.

GENERAL COMMENTS FROM AFG:

AFG wishes to express several general comments before entering the details of the questions raised by CESR.

First, we consider that even if it was not intended by CESR, the proposed standards would increase the current unlevelled playing field between the asset management industries and other financial product industries. Readers of CESR's consultation paper might have the misleading feeling that inducements relate only to the management industry and to investment funds. The series of 10 examples delivered by CESR in its consultation paper is exclusively oriented to cases related to funds/UCITS or to activities provided by portfolio management companies or investment management companies.

Beyond our request for extending the scope of financial instruments or services under review in its forthcoming final paper, we wish CESR to change its approach – which currently creates in itself an unlevelled playing field among financial instruments. The types of distribution arrangements tackled by CESR do not apply to some categories of financial instruments. Following CESR's current consultative paper, those categories would then remain in any case out of the scope of inducements as currently understood by CESR.

The paradox would be then the following. UCITS are currently the most transparent financial instruments on the financial markets: as you know, the prospectuses of UCITS disclose the maximum threshold of fees taken on the relevant product and even more importantly the so-called Total Expense Ratio (TER) which includes the distribution fees among others – beyond the direct management fees. By orienting its reflection towards arrangements which apply more to such products, CESR's paper might contribute to act against investors' protection by encouraging distributors to offer less transparent products to investors (less transparent both regarding costs and also regarding the settlement of the prices; by contrast, in the case of UCITS, the NAV ensures a high degree of transparency in the method used for settling the price to be paid by the investor).

Second, throughout its paper, CESR tends to mean that in general distribution fees are inducements per se, and therefore are not allowed except in very narrow cases and when they are disclosed. **We consider that in any industry, producers and distributors are both needed**. The term distributor means any provider which gives access to clients, such as 'placement provider', or 'business introducing provider'. In any industry, the client has to pay both the producer and the distributor through a single payment. Why couldn't such a general principle of fees exist in the field of financial services? *As such, distribution fees are part of the costs of the product; they are not superfluous costs, i.e. inducements*. In the real life, for investment funds, in all continental European countries, distribution agreements (including retrocessions) between distributors and managers are *consubstantial* for ensuring the access by the investor to the managed product.

In the EU, two approaches are currently followed for the remuneration of distributors: either high front-load fees, often received directly by the distributor (in the UK and Ireland) or retrocession of a part of management fees of UCITS, given by the management company to the distributor. If you compare for instance the structure of remuneration between France on the one hand and the UK/Ireland on the other hand, you will notice a significant gap regarding the level of front-load fees (see Les Echos newspaper, 05/02/07):

	Total Expense Ratio (TER)	Front-load fees + TER

France	1.13%	1.67%
Ireland	1.72%	2.67%
UK	1.32%	2.32%

Retrocession of a part of management fees, as compared to high front-load fees, are beneficial to the clients and are necessary for some types of funds:

- for the clients, retrocessions allow for a higher flexibility in moving from one fund to another one – which will be good for him in case of market turmoils;
- retrocessions are strictly necessary for money market funds to which usually front-load fees are not applied;
- retrocessions are a way for distributors to maintain in the medium term a significant part of their selling forces to the subscriptions/redemptions (and service to clients after the subscription) of UCITS and to keep investing a lot in training in order to answer investors' protection – which will be even more required in the coming months through the MiFID provisions.

More widely, our value chain requires necessarily on the one hand a management company and on the other hand an entity providing access to clients. In particular, *retrocessions are the fair remuneration of a specific service provided by the distributor to the producer, and the distributor has to be paid for this service*. If the fund or its management company were to bear the full cost of marketing directly by itself the units of the fund, such costs (e.g. advertisement, cost of sale forces and distribution outlets, information to clients, shareholder record keeping, shareholder servicing) would be incurred directly by the product provider out of its management fee or directly charged to the fund (as it is the case for shareholder record keeping and shareholder servicing fees in the US). In continental Europe, many of these costs are incurred by the distributors and the commission paid by the product provider to the distributor compensates for such services rendered to the producer. In the case of UCITS, the potential client is well informed: as acknowledged by MiFID, the simplified prospectus provides sufficient information about the costs and charges of the product and the client is able to assess by him(her)self the overall quality of the service given the cost and TER paid.

Without these existing arrangements that CESR seems to contest, the European management industry could not live further on.

It could be considered that for funds, the activity of distribution/fund placement encompasses two parts: a relation between the producer and the distributor and a relation between the distributor and the client. Regarding the latter relation, let us recall here that according to Recital 39 of MiFID Level 2, such advice delivered to the client should be considered as designed to enhance the quality of the service to the client in circumstances where the advice is not biased as a result of the receipt of commission. We consider that setting up a conflict of interest policy in line with MiFID requirements (Art. 22 MiFID Level 2) would then allow for dealing with Recital 39 (by avoiding any bias). *More widely, only the commissions or fees which involve a potential conflict of interest should be legally qualified as 'inducements'*.

In addition, we wish to mention the fact that the products mentioned in CESR's paper are only products the distribution schemes of which are based on fees**.** *In any case, the point for the client is not to be aware of the purely inter-business deal between the professionals involved in the value chain, but to be clearly informed of the total cost of what he/she pays for (or as a maximum, of the existence of retrocessions).* In our view, the overarching aim of CESR should be to ensure a level playing field among products in terms of transparency of **total**

costs to be paid by the investor (see the table above), and not to focus instead on transparency of costs paid between professionals.

Last but not least, not from an economic point of view but from a legal one, it could be considered that Art. 19(1) of MiFID Level 1 regarding the obligation of acting nonestly, fairly and professionally applies in any case to any fees and commissions, including those not strictly covered by Art. 26 MiFID Level 2.

Third, we have doubts on CESR's implicit position regarding the application of MiFID to the subscription or redemption of UCITS units. In our view, subscription/redemption of UCITS units does not clearly fit with any of the MiFID services as annexed to the Directive. In particular, we do not know still how to make a link between on the one hand the existing notions of 'placement' and 'distribution' as currently applied to UCITS' units in several Member States (based on the existing UCITS Directive) and on the other hand the MiFID services. It is crucial to notice for instance that the existing taxation rules on VAT have made clear that the notion of 'placement fee' for funds' units covers both the activities of issuance and of distribution of funds' units. Since this autumn, we have been waiting for an interpretation by the European Commission on this issue linked to the specificity of funds' units.

Fourth, it seems that CESR favours the approach of letter b as compared to letters a and c. CESR states that the cases for letters a and c is narrow in practice. Such a statement looks rather strange in our opinion and cannot be legally substantiated. For instance, many cases allow in practice for a fee to be paid by the client or a person on behalf of the client, in accordance with letter a as we will see below, in particular for mandates. Regarding the distribution of funds, the consubstantial need for a link between a producer and a distributor (as explained above) would fall in some cases under letter c, in other cases under letter a (when instruction is given by a client in a mandate for example), and could also be out of the scope of Art. 26 (service of reception-transmission of orders between two eligible counterparties for example, following Art. 24 MiFID Level 1). In any case, we could of course envisage setting up professional Codes of conduct which would ensure fair inducements.

Fifth, we are afraid that the general orientation given by CESR's consultation paper might reduce the choice of financial products offered to the investor, by making open architecture more difficult. Clearly, CESR has to be neutral regarding the future developments of the industry. As a reminder, open architecture allows independent distributors to widen the offer of financial products, such as funds, to investors. If CESR's general position were to be kept, the constraints it would create would narrow this scope of products offered to the investors – at the final expense of the client.

Sixth, we have a strong doubt on the potential use which could be made by clients and by regulators of the list of factors proposed by CESR in the context of letter b of Art. 26. During the CESR Open Hearing on 2 February 2007 (and for which we are grateful to CESR for having accepted to register our participation), we understood from CESR representatives that this list of factors is aimed at helping professionals to identify if an item is designed to enhance the quality of a service to the client and does not impair the duty to act in the best interests of this client. We understand CESR's point of view, but we think that in practice this list of factors is potentially very dangerous. There is a high risk that this list of factors be used not only by professionals but also by clients in the context of litigations and by regulators in

assessing the compliance or not of practical cases of inducements with the Directive requirements. We consider this list of factors might even become more dangerous for professionals than the provisions of the Directive itself, in particular through the introduction of new *subjective* elements, such as the sort of 'proportionality test': how to assess the proportionality of the benefits received by a firm as compared to the benefits received by the client? Therefore we do not see any added value offered by this list as compared to the relevant provisions of the Directive. We wish CESR not to keep such a list of factors.

Seventh, we have a last general concern regarding the level playing field between regulators which is not at all solved by this CESR Level 3 work. How does CESR intend to ensure a level playing field from one country to another one in practice, in the daily behaviour of regulators? Level 3 standards might be implemented through binding texts in some Member States, not in others. But as long as national transpositions and behaviours of national regulators will be different from one Member State to another one, the risk of regulatory dumping and arbitrage will remain. This risk is clearly against the general aim of a Single Market – which must be developed on harmonised rules and regulators' behaviours (as long as a single European securities regulator has not been created).

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DETAILED COMMENTS FROM AFG:

General explanation and relationship with conflicts of interest

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?

Although Art. 26 applies to many fees, we cannot not consider this Art. applies per se to all fees in relation to the provision of investment services to a client, as this wording "all fees" seems rather ambiguous: Art. 26 could only relate to fees *strictly* related to the provision of such investment services. It could be even considered that Art. 26 only applies where inducements as such exist, i.e. means to bias the provision of the service to the client. In any case, an exhaustive list of examples cannot be provided.

Second, as mentioned in our general remarks and from a legal point of view, letter c and letter a provisions cannot be restricted by CESR as it suggests to do. In this very first part of CESR' consultation paper, we contest in particular the statement of CESR in paragraph 6 that Art. 26(c) is restricted. Legally speaking, the costs mentioned in Art. 26(c) MiFID Level 2 are clearly non-exhaustive but only *illustrative*, as they are quoted by the wording "*such as…*". For instance the notions of 'placement', 'distribution' and 'business introducing' fit with letter a or with this letter c, taking into account that (i) the client of the distributor could be the asset manager i.e. the producer and/or (ii) the placement activity is necessary for the provision of the management of the product and does not give rise to conflicts of interest as they are embedded within the relevant service itself.

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?

We understand that professionals have to comply both with Articles 21 and 26. But let us mention that standard commissions or fees for a service should not per se give rise to conflicts of interest: as soon as the client is informed of the total fees (including distribution fees), there should be no conflict of interest issue left vis-à-vis the client. Only those commissions or fees which involve a potential conflict of interest should be legally qualified as 'inducement'. Our narrow interpretation of Art. 26 in connection with Art. 21 is even reflected by CESR itself in some parts of its consultation paper, such as in paragraph 35, which limits the arrangements to those "*that can influence or induce*" the investment firm which has the direct relationship with the client. We regret that such an approach has not been followed by CESR in its whole paper.

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

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?"

According to CESR (para 12), Art. 26(a) applies "*in fairly restricted circumstances.*" We strongly contest this interpretation and its very limited substantiation by CESR. On the contrary, we consider that the wording of Art. 26(a) does not prevent from having a wide interpretation of letter a, and authorises fees as long as they are paid by the client or a person acting on his/her behalf. For instance in the context of portfolio management, the level of fees (including retrocessions) is already mentioned in the mandates: those mandates set up the transparency and retrocession rules to be followed, and these mentions are disclosed to the client. For other investment services, similar requirements could exist.

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?"

See above, as well as below through several non-exhaustive examples.

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

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

Yes.

First of all, in our opinion, 'designed to' means that there must be an ex ante intent, but without any obligation of result afterwards. In addition, it must cover a general aim of enhancing the service and not an approach on a client-by-client basis.

Second, we do not understand why, through 7 examples out of 8, CESR concentrates so much its analysis (and the potential prohibitions/restrictions it implies) on management companies, portfolio managers and/or investment funds. Beyond the fact that our members, i.e. 400 management companies, from their daily experience, do not share CESR analysis in several cases – and therefore the potential legal duties involved – we ask CESR to widen its approach of inducements to the whole scope of financial instruments covered by the MiFID (or even beyond, i.e. substitute products). The ultimate mission of CESR is to ensure investor's protection, which requires first to ensure a level playing field within the whole range of financial products the investor is facing, for instance in the context of investment advice.

Third, on the examples submitted by CESR, we do not share many if its analysis. We noticed that in a lot of cases CESR seems to make a confusion between the different types of services that are involved in the transactions and, in particular, neglects completely the other services that can be involved between intermediaries.

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*": we consider that the idea to introduce a 'proportionate commission test' is very dangerous for the professionals. As CESR itself mentions it, it is not possible to set a cap on the level of commission. Therefore it will be for the professional to be able to prove that the commissions are proportionate. The difference of appreciation and enforcement from one national regulator to another one might lead in particular to litigation risks by clients and prosecution risks by regulators.

The specific case mentioned fits with 26 (a), not 26 (b), as soon as the management company is paid directly by the client - which has signed for being informed of the existence and the amount of retrocessions. Conversely, if the clients were not informed, then this case would fall under letter b.

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*": same remark as for example 1, regarding the 'proportionate commission test'. The case mentioned fits with 26 (a) (direct distribution relation between the distributor and the producer) but not with 26 (b), in the case of a management company distributing the products of a UCITS management company without advice. This case could be even put out of Art.26 if we consider that the UCITS placement activity falls within the UCITS Directive (as part of the collective investment activity as annexed to the UCITS Directive) and is therefore out of the scope of the MiFID.

Example 3: "*An investment firm acts as portfolio manager (or as a receiver and transmitter of orders) and transmits orders to brokers for execution*": this case of retrocession of brokerage fees is prohibited in France.

Example 4: "*A management company of a UCITS provides training to the staff of an investment adviser that is an investment firm*": we are worried about the 'proportionate benefit test', for the same reasons as for the 'proportionate commission test'. In addition, such a case should not be dealt by Art. 26 but through the dealing of conflicts of interest (Art. 21) or Codes of conduct.

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. »:* we consider that introducing clients to another investment firm does not constitute an investment service as such. As G introduces the client to F, the provision of the service is between F and the client and the ex ante relation between the client and G cannot be considered as an investment service as such. Therefore the relationship between G and F does not enter the scope of the MiFID. Another approach could be to place this case under letter c as this service is necessary to the activity of the investment firm F (distribution channel).

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. »:* as a principle, we would agree to include such case within 26 (b). But we consider that the mentioned case of a one-off bonus is usually irrelevant: usually retrocession commissions are applied in a progressive way. In addition, volumes do not usually generate conflicts of interest (as the potential conflicts are identified ex ante and managed). Moreover, volumes may improve the quality of the service (degressive cost of transactions with a higher volume).

Example 7: *« A broker provides to an investment manager general office equipment such as computer equipment. »:* we consider that this case is out of the scope of Art 26 as being not linked to an investment service provided to a specific client. It should be dealt within the context of conflicts of interest or codes of conduct.

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*": we consider this case could be put under Art. 26 (a), if it is made clear in the portfolio management mandate that the firm is to recover such commissions on behalf of the client from the UCITS management companies to partly remunerate the portfolio management service. CESR comments also seem to imply that in the context of portfolio management services such fee would necessarily create a conflict of interests between the firm and its clients. With regards to the firm's duty to act in the best interest of its client, we believe that there are various mechanisms that can be set up to manage such conflicts of interests and it should not be presumed that portfolio managers cannot manage such conflicts.

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 suggestion for further factors?

As already mentioned above, we contest the tests of 'proportionate benefit' and 'proportionate commissions', which would lead to legal risk for professionals facing both clients (litigation risk) and regulators (prosecution risk). And more generally we contest this use of factors (see our general comments above): we want this list of factors not to be kept by CESR.

Article 26(b): disclosure

Question 7: Do you agree that it would 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?

Before answering this question, let us first stress that CESR concentrates its analysis on investment funds. Once again, we regret this bias from CESR in its analysis of the scope of financial instruments and would encourage it to widen its analysis to the other financial products of the MiFID or even beyond, when drafting its final guidance.

On Question 7, we agree for having a summary disclosure.

However, we contest the fact that this summary disclosure must provide "*sufficient*" information in order for the client to make an informed decision: this summary disclosure should be only *one of the pieces* of information to be taken into account by the investor, but it should not be required to provide "sufficient information". Otherwise professionals might be at legal risk vis-à-vis their clients.

On the other hand, a generic disclosure would not be enough as it would not comply then with the last paragraph of Art. 26.

We therefore suggest CESR not to provide any guidance on disclosure, as the Level 2 provision gives in itself enough guidance.

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?

In our view, Article 26 should only applies to payments provided or obtained by investment firms having the direct relationship with the client. The other payments in the distribution

chain between professionals should be excluded from Art. 26 and be dealt through the provisions of conflicts of interest (Art. 21 and 22).

Tied agents

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.

Once again, the example raised by CESR is mentioning investment funds, and we ask CESR for providing examples based on other financial instruments.

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

No

Softing and bundling arrangements

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

Considering the current work carried out at global level by IOSCO, it might be useful to have a common approach at EU level on these issues. But for the time being it does not seem necessary to ask CESR for more details on these topics in the context of Level 3 MiFID guidance.

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If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), Stéphane Janin, Head of International Affairs Division, at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or Catherine Jasserand, Deputy Head of International Affairs Division, at 01 44 94 96 58 (e-mail: c.jasserand@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon