# MiFID Supervisory Briefings

# Inducements

Ref. CESR/08-734

## The Committee of European Securities Regulators

CESR is an independent Committee of European Securities Regulators. The role of the Committee is to:

- Improve co-ordination among securities regulators;
- Act as an advisory group to assist the European Commission, in particular in its preparation of draft implementing measures in the field of securities;
- Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.

## Promoting supervisory convergence

In the run-up to the implementation deadline for the Markets in Financial Instruments Directive (MiFID) on 1 November 2007, CESR devoted a lot of energy to setting recommendations and guidelines to help regulators take a consistent view of MiFID. With MiFID now in force, CESR's focus has shifted to matters of co-ordination and convergence of supervisory outcomes. This supervisory briefing builds up from the CESR recommendations Inducements under MiFID CESR/07-228b[1].

As part of its work to promote supervisory convergence, CESR has produced a series of supervisory briefings on the key elements of MiFID. They have been designed for supervisors, summarising the key elements of the rules and explaining the associated objectives and outcomes. The contents of these briefings are not exhaustive and do not constitute new CESR policy.

As well as an accessible introduction to the rules, the briefings also include indicative questions that supervisors could ask of themselves or a firm to assess a firm's approach to applying the rules. Naturally these questions are not intended to be exhaustive or to cover every possible situation, but can serve as a useful starting point when supervisors are deciding on areas of supervisory focus.

The briefings don't promote any particular way of supervising the rules, and are designed to be used in the way that best fits with a given supervisor's own methodology, whether this means distributing the briefings internally, or passing them to external bodies, such as auditors.

CESR believes that promoting convergence of supervisory outcomes can help promote market integrity and market confidence, whilst also minimizing the potential for client detriment and reputational risk, and has designed these briefings to support these goals.

## Inducements

The MiFID Inducements rules give firms a certain degree of flexibility to adopt different approaches in ensuring compliance. In some circumstances, supervisors will have to assess the adequacy of a firm's arrangements on a case-by-case basis.

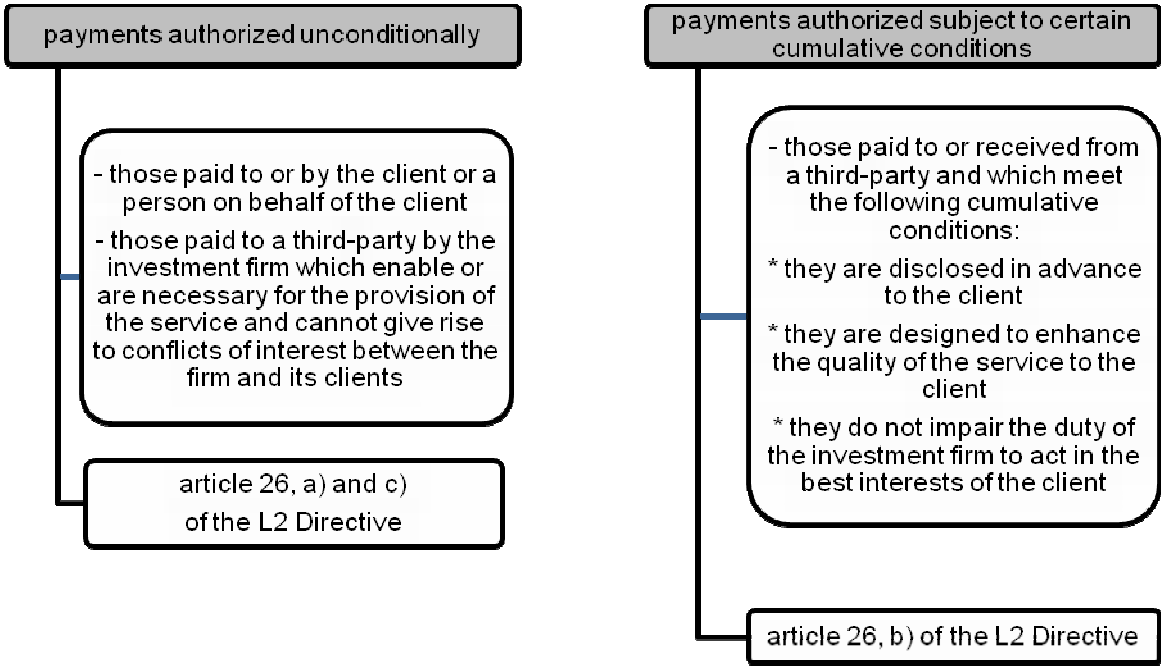
This supervisory briefing is designed to help supervisors make these assessments, and is structured around three headings: (1) Classifying payments and setting up arrangements and procedures necessary to be compliant; (2) disclosure and (3) the duty to act in the best interest of the client and the design to enhance the quality of the service.

Each heading includes an overview of the outcomes that the rules promote, illustrates the potential risks, and provides examples of the sort of questions that supervisors could ask to test whether the outcomes are being met by firms.

[1] http://www.cesr-eu.org/index.php?page=document_details&id=4608&from_id=53

## 1. Classifying payments and setting up arrangements and procedures necessary to be compliant

According to Article 26 of the L2 Directive - which stems from Article 19(1) of the L1 Directive[2] - there are two categories of fees, commissions or non-monetary benefits (hereinafter "payments") which investment firms are permitted to make or receive :




These new rules apply to payments linked to services provided to retail and professional clients but not to eligible counterparties[3].

A firm should review all third party payments it makes or receives in relation to the provision of an investment or ancillary service to the client in order to assess its admissibility. It should also set out **arrangements and procedures** which enable it to meet the requirements of Article 26 of the L2 Directive on an ongoing basis.

### Questions

- What arrangements and procedures, including ongoing arrangements and procedures, has the firm set up to ensure that payments it makes or receives in relation to the provision of investment or ancillary services - including intra-group payments - comply with the MiFID inducements rules? Who was involved in developing these arrangements and procedures?
- How do the arrangements and procedures of the firm lead to the classification of third party payments (made or received) - including intra-group payments[4] - within the various categories of permitted third party payments?
- Did these arrangements and procedures have an impact on the firm's previous practices regarding payments? For example, has the firm stopped making/receiving any third-party payments as a result of the MiFID inducements rules?

---

[2]Article 26 of the L2 Directive stems from the investment firm's obligation under MiFID to act honestly, fairly and professionally in accordance with its clients' best interests. The situations in which payments may be made or received by an investment firm should ultimately be evaluated against this principle.

[3] The eligible counterparty regime only exists for the services of execution of client orders, reception and transmission of orders, and dealing on own account.

[4] As recalled by CESR in its recommendations on inducements under MiFID (p. 5, point n°5) : "the scope of application of Article 26 is the same in relation to payments between firms that are members of the same group as it is to payments between firms that are note members of the same group".

- Has the firm already had to take corrective measures regarding its payments' arrangements and procedures to ensure compliance with the MiFID inducements rules and, if so, which measures has it taken?
- Have the payments' arrangements and procedures of the firm been the subject of any complaint(s)?
- What are the interactions between the firm's arrangements and procedures for compliance with the MiFID inducements rules and the firm's conflicts of interest policy and procedures?
- Payments that fall in the category of 'proper fees' (article 26(c)) include custody costs, settlement, exchange fees, regulatory levies and legal fees. Can you list any other payment that can fall within the category of 'proper fees'?
- What information does the senior management receive on compliance with the MiFID inducements rules and how does the latter satisfy itself that the firm is and will remain compliant?
- Has the relevant staff been informed of the impact of the MiFID inducements requirements?
- What record of payments made or received in relation to the provision of investment or ancillary services does the firm maintain? Does the firm look for possible correlations between the payments record and decisions taken by the firm that affect clients' interests ?

## 2. Disclosure

Payments under Article 26, b) of the L2 Directive may only be made or received where the existence, nature and amount of the payment (or, where the amount cannot be ascertained, the method of calculating that amount) is **clearly disclosed** to the client before the provision of the investment or ancillary service to the client and in a manner that is comprehensive, accurate and understandable.

This disclosure may be done in a summary or in a detailed form. If the firm decides to disclose only the essential terms of the payments' arrangements (summary form), it must then undertake to disclose further details at the request of the client and honour that commitment. Even when given in summary form, the disclosure must provide sufficient information to enable the client to relate it to the particular investment or ancillary service that is provided to him, or to the products to which it relates, **to make an informed decision** whether to proceed with the investment or ancillary service and whether to ask for the full information.

### Questions

- How and in what documentation does the firm disclose the existence, nature and amount of the third-party payments (or where the amount cannot be ascertained, the method of calculating that amount) to the client?
- How does the firm satisfy itself that the information provided is comprehensive, accurate and easily understood by its clients?
- When are disclosures (in summary form and/or more detailed) under the inducements rule made to the client?
- Does the firm make the disclosure in a summary form? If the information is provided in a summary form, how does the firm deal with requests from clients to provide more detailed disclosure?
- How does the initial disclosure provide information about third-party payments? Does it provide such information by using bands of third-party payments that can be made/received, or does it provide the specific amount?
- Has there been any feedback from clients about the disclosures, including requests for further details after being given a summary disclosure?
- Is there any difference in the way the firm makes disclosures depending on whether they are made in relation to the provision of a service to a retail client or to a professional client and, if so, why?

## 3. The duty to act in the best interests of the client and the design to enhance the quality of the service

Payments under Article 26, b) of the L2 Directive may only be made or received where they are **designed to enhance the quality of the relevant service** to the client and do not impair compliance with the firm's duty to act in the **best interests of the client**.

Payments may enhance the quality of the relevant service to the client in different ways and it is the task of the firm to establish - prior to making or receiving the payment - why and how it enhances the quality of the relevant service to the client[5]. Besides, the firm should also ensure that such payments do not impair compliance with duties it owes to the client.

## Questions

- How – in relation to each service provided – does the firm determine whether third-party payments it makes or receives are designed to enhance the quality of the service to the client[6]? If the third-party payments are designed to enhance the quality of the service, in what way do they achieve this? Does the firm adopt the same approach regardless of the type of third-party payment concerned (intra-group or not)? If not, how is the difference of approach justified?
- How –in relation to each service provided– does the firm assess the risk that conflicts could arise as a result of making or receiving payments to or from third-parties, and ensure that these are managed so that the payments do not conflict with a duty owed to the client[7] ?
- What is the nature of the third-party payments in relation to the provision of investment or ancillary services and under what circumstances are they made or received[8]?
- When assessing the risks that conflicts could arise as a result of making or receiving payments to or from third-parties, does the firm take into account the nature of the relation between itself and those third-parties[9]?
- Within the enhancement and interest of the client test, are there any differences in the firm's approach across the EU?
- On average, what is the ratio between payments made by the client to the firm in relation to the provision of a service and payments the firm receives from the provider of the product (financial instrument) subject of that service[10]?
- If payments under Article 26, b) of the L2 Directive are the main or only source of income of the firm, how does the firm demonstrate compliance with the enhancement and best interests of the client tests?
- How does the firm ensure that the advice or general recommendations given to their clients are not biased as a result of payments received[11]?
- Is there any difference in importance between the amount of the payments received from product providers within the group ("house products") and payments received from third-party product providers ("open architecture")?

---

[5] See CESR recommendations on inducements under MiFID (Ref. CESR/07-228b).

[6] This question relates to recommendation 4 (a) of the CESR recommendations on inducements under MiFID, which includes the type of the investment or ancillary service provided by the investment firm to the client and any specific duties it owes to the client in addition to those under Article 26 of the L2 Directive among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client.

[7] Idem.

[8] This question relates to recommendation 4 (e) of the CESR recommendations on inducements under MiFID, which includes the nature of the inducement among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client.

[9] This question relates to recommendation 4 (d) of the CESR recommendations on inducements under MiFID, which includes the relationship between the investment firm and the entity which is receiving or providing the benefit among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client.

[10] This question relates to recommendation 4 (b) of the CESR recommendations on inducements under MiFID, which includes the expected benefit to the client(s), including the nature and extent of that benefit, and any expected benefit to the investment firm among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client.

[11] This question relates to recommendation 5 (a) of the CESR recommendations on inducements under MiFID, which states that "Recital 39 makes clear that where an investment firm provides investment advice or general recommendations which are not biased as a result of the receipt of commission then the advice or recommendations 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 to act in the best interests of the client – must be met".

- Is there any difference in the way the firm deals with third-party payments depending on whether they are made/received in relation to the provision of a service to a retail client or to a professional client and, if so, why?
- What proportion of your firm's revenue in respect of the provision of investment services do you estimate comes from third-party cash payments?

---

*This note has been prepared by the CESR MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its sub-Group on Intermediaries, chaired by Mrs María José Gómez Yubero, Director at the CNMV. For more information on this document or on CESR activities regarding intermediaries please contact Diego Escanero at descanero@cesr.eu.*

*The contents are merely illustrative and do not constitute legal advice. The MiFID legal texts are available at http://ec.europa.eu/internal_market/securities/isd/index_en.htm*