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Via: www.cesr-eu.org/consultations

9 February 2007

Dear Sirs

CESR's Consultation on Inducements under MiFID

I. Background

The Regulatory Committee of the City of London Law Society (the "Committee") is responding to the above consultation. This response is set out in broadly the same order as the questions posed in the consultation. However, the Committee has not sought to answer every question, but is responding to those issues where it believes that there are issues of legal interpretation.

The City of London Law Society is the local Law Society of the City of London. Members of the Committee advise a wide range of firms in the financial markets, including banks, brokers, investment advisors, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as trading, clearing and settlement systems.

II. Response

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?

We can see that CESR's wide interpretation reflects a literal reading of the text, without regard to the heading of the section. We consider however that the purpose of the provision was to affect payments etc. which could operate as inducements to an investment firm to act in a way which may not be in its clients' interests. If this were not the case then the section would not be entitled "Inducements". We are concerned that an interpretation as broad as that suggested by CESR has the potential to impact on standard market arrangements which would not be thought of as "inducements". We believe that CESR' approach seems to be focussed on retail markets and therefore pays too little attention to the implications of such a reading for other activities, such as financing and corporate finance transactions.

CESR's paper does not consider the scope of the term "in relation to" which is also highly relevant to a proper application of the provision. For example, if in order to provide a client with a particular structured product a firm enters into other transactions to put it in a position to provide the product to the client, payments made or received by it in connection with these transactions are not "in relation to the provision of the service to the client". Clarity on the scope of this important phrase could reduce the concerns we have about unforeseen implications of CESR's approach.

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?

For the reasons given above, we consider that the analysis of the general operation of Article 26 may be too literal and not pay sufficient attention either to the purpose of the provision or the meaning of the phrase "In relation to the provision of a... service to the client" (see below). We do agree that it interacts with Article 21 because Article 21 concerns conflicts of interest, and we believe that Article 26 addresses the same core issue.

The Law

Recital 40 of the Level 2 Implementing Directive provides:

> "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."

"Inducement" is defined in the Concise Oxford Dictionary as "an attraction that leads one on", "a thing that induces". "Induce" is defined as "prevail on", "persuade". We believe that the text in other languages also supports an interpretation of "inducement" as being something that "incentivises".

Article 21 of the Level 2 Implementing Directive refers to the question of whether a firm receives from a person other than a client "an inducement in relation to a service provided to the client" as a type of conflict of interest, and it is a further implementing measure for Article 13(3) and Article 18 of MiFID - both of which are concerned with the management of conflicts of interest.

Article 26 is titled "Inducements" and contains further provisions on the subject of inducements and is referable to Article 19(1) of MiFID, which is concerned with an investment firm acting honestly, fairly and professionally in accordance with the best interests of its client.

The legal interpretation of Article 26 has to be in the context of this framework. We would agree that the drafting of Article 26 opens up the possibilities of different interpretations, but this is not unusual in the case of Directives, and it is not therefore unusual to find that a provision needs careful interpretation in order to tie together the Recitals, the provisions and common sense. Indeed there are other examples of exactly this kind of issue in relation to other securities markets directives. The natural flavour of the provisions and the recitals is that the purpose is to control arrangements which

could affect a firm's judgement. This is the natural meaning in the various languages of the term "inducement" and fits well with the mischief at which regulation is directed. It is not generally thought that regulators should have the ability to interfere in commercial arrangements which could not have this effect.

The approach apparently favoured by CESR is to stretch the wording to cover any payment whether or not an inducement. Such an approach produces a disproportionate outcome and unacceptable and unnecessary regulation. We doubt that either industry or CESR has fully understood the potential commercial implications of such an interpretation.

Thus we consider that it is important to accept that an inducement is something which affects judgement, that this is borne out by the various texts, and that it is then necessary to read Article 26 in a way which is consistent with this and with Recitals 39 and 40.

We believe that Article 26 should be read as directed at controlling arrangements for the payment or receipt of fees, commissions or non-monetary benefits which are inducements. Under this reading only Article 26 (b) contains a substantive conditional exception for payments which might be considered inducements. Article 26(a) and (c) are to be considered declaratory of payments which are not within the scope of the mischief being controlled - that is, for the avoidance of doubt, such payments are not "inducements" in the first place. It seems to us that it is clearly the case that any payment or receipt must first be capable of being an inducement before the provisions of Article 26 (b) apply. It will not be capable of being an inducement where no conflict of interest issue arises, or at least where the payment or receipt does not affect the firm's ability to meet the requirement that it act in the best interests of its clients.

Thus we believe that the test of whether something is an inducement is whether it could reasonably be expected to give rise to a conflict with the firm's duty to the client or adversely affect the firm's judgement as to what is in its client's best interests. This is consistent with the way in which the concept is traditionally understood in a regulatory context and with the ordinary meaning of the word or its equivalent in other language versions of the Directive. We consider that as explained above such a reading of the text is indeed the most appropriate, taking all circumstances into consideration.

There are points in the CESR paper where this fundamental issue seems to be recognised. In particular, paragraph 35 refers to the fact that CESR considers that the arrangements that need to be considered and disclosed are those that can influence or induce the investment firm which has the direct relationship with the client.

However, the overall impression is that CESR appears to reject such an interpretation. CESR states in paragraph 5 that some commentators have suggested that Article 26 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. CESR states that "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".

This is not our main reason for believing this to be the case. We believe the interpretation we have suggested to be correct because it is consistent with the Directive, the recital to the Level 2 Implementing Directive and the entire rationale behind a provision called "Inducements". We consider that the issue is not whether payments are made “with the purpose or intent to influence the actions of a firm” but whether they are objectively capable of being an inducement to a firm to act otherwise than in its clients’ best interests. CESR should not attempt to regulate ordinary commercial payment mechanisms, there is no basis for such an interpretation and, indeed, it could cause havoc in the financial markets.

It follows that Article 26(c) is a helpful clarification and we consider that it could apply for example to the payment by a broker of commissions to the brokers that execute its business. The broker charges the client a fixed commission per trade and then pays (out of that sum) amounts (normally termed commissions) to the brokers through whom it executes its business, i.e. the broker absorbs the costs of execution in the same way as it absorbs exchange fees, custody costs, settlement fees, etc. We think that, article 26(c) can apply to these types of payment and that its reference to “fees“ has to be construed as referring to payments in the nature of a fee, including commission. We do not therefore agree that fees not specifically stipulated in Article 26(c) cannot fall within it. Nor do we think that it is a an exclusive statement of the only permitted payments from or to investment firms.

Annex B and Annex C are helpful, save for the fact that they omit one very important step. The second question in each case should be whether the fee, commission or non-monetary benefit is in the nature of an inducement. Without this important step the tables are misleading as to the scope of Article 26.

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"?

We agree that the circumstances CESR describes fall into this category. We do not agree that these are the only circumstances.

The example given by CESR in paragraphs 11 to 14, of a payment made by or on behalf of the client, is interesting but will not always reflect the reality of the way in which for overseas regulatory or similar good reasons payments are structured, with the full knowledge and consent of the client. We refer here, of course, to circumstances where there is no issue of an inducement. We do not think it is necessary for such a payment to have to be constructed as if it is a payment on behalf of the client in order for it to be clear that no Article 26 issue arises.

We agree that there is a difference between this case and the case of a product provider paying a commission share to an investment adviser - where, we agree with CESR, such situations would usually fall under Article 26(b).

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"?

If Article 26 does extend to all payments and not just payments in the nature of inducements, then the number of circumstances of this kind that could exist might well be infinite.

Consider a transaction in derivatives on an exchange. The client has its own clearing broker selected by it but executes through an introducing broker. The client pays commission to the clearing broker directly who then pays an amount of commission back to the introducing broker. The client knows how much he is paying, has selected the introducing and clearing broker and knows they will share the amount he has paid. We think this is an example of a situation that falls outside Article 26 - on these facts there is no inducement issue at all. If it falls within Article 26 then it would have to be construed as a payment by the clearing broker on behalf of the client for the purposes of Article 26, regardless of how it was documented. Any other interpretation would make no sense.

CESR does not really explore the question of who is the "client" referred to in article 26(a). This is relevant to both questions 3 and 4. For example, in example 2 on page 9, the product provider (a management company) is paying a commission to the investment firm/distributor. The discussion in the CESR paper focuses on the position of the investment firm/distributor, but the product provider would also be subject to article 26(a) since it implements article 19 (article 66 MiFID). On other occasions the product provider might also be an investment firm directly subject to article 26(a), e.g. as in the case of retail structured products.

It seems to us that the payment of the distribution fee by the product provider needs to be considered under article 26. However, who is its client here? In some cases, the product provider may have a direct relationship with the underlying client and can make the disclosures contemplated by article 26(b) itself, treating the distributor as a third party (so there would be duplication of disclosure). However, in other cases, the product provider would treat the distributor as the person to whom it is providing services and so the payment would fall within article 26(a). The product provider would have no means of controlling what if any disclosures are made by the intermediary (and it is the intermediary which has the real conflict).

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

We think that it ought to be made clear that if the firm accounts to its client for the fee/commission received from a third party (e.g. pays it on or deducts it from its own fees) that either this does not fall within article 26 at all or is within (a). This seems to be accepted in the discussion of example 3 on page 9 ("There is no condition that the money be repaid to the clients of the investment firm.")

We do not think that the last sentence in paragraph 22 which prohibits a “disproportionate” payment has any legal basis and note that it is not one of the prescribed tests.

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?

We note that under the current FSA Rules, services which are related to the execution of orders and investment research are considered as enhancing the quality of investment management services to a client. These are to be distinguished from things such as the provision of general office equipment, being the example given by CESR.

The wording "enhances the quality of service to the client" is not ideal wording in the case of a firm receiving a fee from a third party - but in this regard Recital 39 is helpful in indicating that in some circumstances such payments are permissible, which itself helps to give context to the meaning of the phrase when applied in such situations. We think that it should be made clear that arrangements which reduce the cost of a service to the client or give the client a financial advantage could be regarded as enhancing the quality of the service, although in any case this will depend on the circumstances.

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?***

We agree it would not be useful for CESR to seek to develop guidance on a summary disclosure. Article 26 already requires the investment firm to disclose "the essential terms" in summary form - what these are and what is sufficient will depend on the service, the client and the nature of the fee, commission or non-monetary benefit.

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?

We agree with CESR that the arrangements that need to be considered and where relevant disclosed are those that concern the fees, commissions and non-monetary benefits received by or provided to the investment firm which is providing the service to the client. The statement of this principle is most clearly made in paragraph 34.

The issue we raise above concerning the identity of the “client” is also relevant here, where CESR's discussion appears to assume that it is only the ultimate client that is a "client" for the purposes of article 26. This seems to be quite difficult to understand as clearly in many cases there will be client relationships further down the chain as well. Paragraph 32 seems to accept this but paragraph 35

appears to be in contradiction. Perhaps the answer is to understand that in these circumstances there are several client relationships but that many of the payments up the chain will be covered by article 26(a) (or will be outside article 26 as involving eligible counterparty relationships outside article 19 MIFID).

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?

No. We agree that the amount for disclosure is €X. We can, however, see that it is in fact €Y that might be considered to be the amount that is actually the influencing amount.

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

We cannot think of any.

Softing and Bundling Arrangements

We found the definitions of "softing" and "bundling" slightly confused. Bundled brokerage is the term usually used to refer to the position where a broker provides services directly to the portfolio manager in addition to the service of executing orders. Such services might include the provision of research, access to analysts and similar facilities. The charge is said to be bundled because there is not transparency as to the amount of the commission which is attributable to the services additional to execution. The term "softing" tends to be used in a circumstance where a broker makes a payment to a third party who supplies a service to the portfolio manager, in effect the portfolio manager pays for that service via the payment of commission to the broker.

It would therefore be more correct if the last sentence of paragraph 42 were to say that where brokerage arrangements are bundled there is no transparency as to how much is paid for execution and how much is paid for other services.

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

It is our understanding that, from a UK perspective, the UK restrictions on softing and bundling will be capable of existing within the constraints of Article 26.

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

In principle it would be helpful, provided that it can be established that there is sufficient similarity across the EU as to the nature of these practices. For example, there may be a practice in some

Member States which is neither softing nor bundling but which has a similar economic effect or effect on the position of the client.

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

We would have thought it appropriate for the Commission to start such work and to do it with the assistance of CESR.

We hope you find the above comments helpful. Please do not hesitate to contact us if you would like further elaboration or information. We would be very happy to discuss this response with CESR. Please contact the chair of the Regulatory Law Committee: Margaret Chamberlain, Travers Smith, 10 Snow Hill, London EC1A 2AL, Tel: 020 7295 3233, Fax: 020 7295 3500, e-mail: margaret.chamberlain@traverssmith.com.

Yours faithfully

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