

CESR CONSULTATION ON “INDUCEMENTS: GOOD AND POOR PRACTICES”

RESPONSE FROM APCIMS (THE ASSOCIATION OF PRIVATE CLIENT INVESTMENT MANAGERS AND STOCKBROKERS)

The Association of Private Client Investment Managers and Stockbrokers (APCIMS) represents firms acting on behalf of investors¹. Member firms deal primarily in stocks and shares as well as other financial instruments for individuals, trusts and charities and offer a range of services from execution only trading (no advice) through to full portfolio management. Our member firms operate on more than 500 sites in the UK, Ireland, Isle of Man and Channel Islands, employing 30,000 staff. Around £335 billion of the country’s wealth is under the management of our members.

APCIMS’ member firms are authorised and regulated by the FSA.

The CESR questions in their Inducements paper are answered in sequence below.

Classifying payments and non-monetary benefits and setting up an organisation to be compliant

Question I: Do you agree with CESR’s views about the arrangements and procedures an investment firm should set up?

Paragraphs 34 to 38 set out CESR’s expectations as to the approach firms should adopt in seeking to comply with the inducements rules. In particular, the paper –

- (1) specifies that firms’ procedures should
 - identify relevant payments
 - classify relevant payments against the Article 26 categories
 - evaluate relevant payments against the Article 26 criteria
 - prevent any payments that do not meet those criteria.

- (2) recommends that firms procedures should
 - ensure that new business relationships that may give rise to relevant payments should be subject to assessment

¹ APCIMS has around 190 members, over 125 are private client investment managers and stockbrokers and the rest are associate members providing related services to our firms.

- establish specific compliance controls/responsibilities vis-à-vis the inducements rules, including “appropriate monitoring”
- be subject to senior management approval
- have their adequacy and effectiveness assessed on an ongoing basis by compliance staff

In addition, the paper makes clear in the “poor practice” example on page 12 that firms should not be relying on their general conflicts of interest policy to ensure compliance with the specific requirements of the inducements provisions.

The above represents a far more detailed approach to inducements than anything envisaged by the UK FSA’s COBS 2.3 rule which currently governs APCIMS’ firms in this area.

APCIMS firms do identify and evaluate payments. But for most member firms setting up of systems against which all payments could be assessed would be a new departure. Any review of COBS 2.3 to bring it in line with the draft CESR paper would thus represent a major regulatory development and additional cost for our firms, especially in the areas of systems and controls, monitoring, senior management involvement etc.

Many firms, particularly smaller ones, may well have combined their compliance arrangements for inducements and general conflicts of interest. COBS 2.3 requires firms to consider payments given/received against the Article 26 criteria but there is nothing to indicate that tackling such payments in the round with other types of conflicts is not acceptable.

So in broad terms our view is that aspects of the CESR approach setting up systems against which all payments could be assessed would represent an important development and new regulatory cost.

Question II: Do you have any comments on CESR's views that specific responsibilities and compliance controls should be set up by investment firms to ensure compliance with the inducements rules?

We agree with the following proposed specific responsibilities and compliance controls:

- appropriate monitoring and procedures to deal with the specific conflicts of interest related to inducements;
- that the general approach on inducements should be approved by the senior management of the firm;
- that the compliance function of the investment firm should assess on an ongoing basis the adequacy and effectiveness of the measures and procedures put in place in accordance with the inducements rules;
- that in discharging this responsibility the compliance function needs to have both the support of the firms’ senior management to enable it to challenge decisions made by the operational part of the business and the skills and knowledge necessary to assist the business in ensuring that the firms policies, in particular its conflicts policy, are adhered to.

In the main, APCIMS firms already tend to follow these processes.

We also agree that the compliance function should **consider** inducements in its compliance reports to senior management, but that this ought not to be a requirement. APCIMS does not see the reason for this requirement being imposed on all firms and considers that this should be a discretionary matter for each firm to take into account based on its business model and the risks it runs.

Question III: What are your comments about CESR's view that at least the general approach the investment firm is going to undertake regarding inducements (its 'inducements policy') should be approved by senior management?

We agree that that the general approach on inducements should be approved by the senior management of the firm.

Proper fees

Question IV: Do you agree with CESR's view that all kinds of fees paid by an investment firm in order to access and operate on a given execution venue can be eligible for the proper fees regime (under the general category of settlement and exchange fees)?

Yes.

Question V: Do you agree with CESR's view that specific types of custody-related fees in connection with certain corporate events can be eligible for the proper fees regime?

Yes.

Question VI: Are there any specific examples you can provide of circumstances where a tax sales credit could be eligible for the proper fees regime?

No.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – acting in the best interests of the client and designed to enhance the quality of the service provided to the client

Question VII: Do you agree with CESR's view that in case of ongoing payments made or received over a period of time while the services are of a one-off nature, there is a greater risk of an investment firm not acting in the best interests of the client?

Paragraph 65 identifies two types of non monetary benefits (NMBs):

- *The first was in relation to the distribution of products. Operators of CIS provide training for the staff of investment firms to help them to understand the funds they operate. They may also provide other non-monetary benefits such as marketing material, research, hardware and software and other IT products.*
- *The second was where brokers provide non-monetary benefits to investment firms providing portfolio management services in addition to providing the service of the execution of orders. These benefits can include the provision of research, data feeds and IT software and infrastructure.*

As regards the first bullet above, we have formally stated to FSA in our response to CP 09/18 on the Retail Distribution Review (RDR) that the FSA should do away the existing “reasonable non-monetary benefits” regime. Amongst the amendments to the COBS 2.3 inducements provisions proposed in CP09/18 are new conditions for the offering/receipt of NMBs. These conditions are in our view somewhat naïve, for example in suggesting, on the one hand, that product providers should offer NMBs to all adviser firms rather than just rewarding those firms that sell their products and, on the other, that adviser firms should not accept NMBs on which they will need to rely. Given that the FSA’s NMB regime creates an unlevel playing field between APCIMS’ firms, who have to apply the inducements to all payments given/received, and product

provider/adviser firms, who are effectively given a list in COBS 2.3.15G of the NMBs that will be deemed to meet the enhancement test, we agree with CESR's comment that such NMBs give rise to "very significant potential conflicts" and believe that the FSA should adopt this view.

As regards the second bullet above, this is an area where the UK is ahead of the game. FSA's COBS 11.6 (use of dealing commissions) regime basically put an end to the "softing" free-for-all that had previously existed between institutional brokers and their clients by very clearly limiting the types of goods/services which could be provided in return for business flow/commission income. The COBS 11.6 rules seem to meet CESR's concerns in this area pretty exactly and we would not want to see them affected by CESR's specific recommendations.

In short, we would oppose any major amendment to COBS 11.6 brought about by the CESR text. This would not improve the situation in the UK and would entail unnecessary costs to businesses.

We also recognise our firms' concerns about disclosure.

Question VIII: Do you have any comments regarding CESR's view that measures such as an effective compliance function should be backed up with appropriate monitoring and controls to deal with the specific conflicts that payments and non-monetary benefits provided or received by an investment firm can give rise to?

No, other than to agree with CESR's view.

Question IX: What are your comments on CESR's view that product distribution and order handling services (see §74) are two highly important instances where payments and non-monetary benefits received give rise to very significant potential conflicts? Can you mention any other important instances where such potential conflicts also arise?

Please see our comments in Question VII.

Recital 39 of the MiFID Implementing Directive states: *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.*

We are of the view that Recital 39 has been widely interpreted as giving carte blanche for the continued receipt of product commissions – firms have latched on to the seemingly automatic "pass" vis-à-vis the Article 26(b) enhancement test without picking up on the wider Article 26(c) requirement for a firm to act in the best interests of its client. The CESR paper touches on this issue in a number of places in a way which seems to run counter to the way in which Recital 39 has been generally interpreted. For example –

- paragraph 41 states : *The possibility of a receipt of a standard commission or fee is of a nature to give rise to conflicts with the duty owed to clients.*
- paragraph 51 states : *rebates from product providers to an investment firm providing portfolio management services represent a crystal-clear case of an item which is not a proper fee under Article 26(c) of the Level 2 Directive regime, since by their nature they can give rise to conflicts of interest and they are not necessary for the provision of the service.*

The only place where Recital 39 is explicitly mentioned is on page 26 where emphasis is placed on the bias/best interests issues. However, given that the UK will be banning the offering/receipt of product commissions altogether via the RDR, we believe that that Recital 39 itself should be subject to review, not least because it provides what many have taken to be a general green light to continue commission practices which in our view are harmful to client interests.

Question X: What are your comments on CESR's view that where a payment covers costs that would otherwise have to be charged to the client this is not sufficient for a payment to be judged to be designed to enhance the quality of the service?

We agree with CESR's view.

We are interested to learn FSA's view: *"It should be noted that the application of Article 26 of the Level 2 Directive is the same in relation to payments and non-monetary benefits within the same group as the investment firm as it is to payments and non-monetary benefits provided to or by any legal entity outside the group."*

It should be noted that in the UK CESR's statement about intra-group payments could have a major impact upon how the FSA decides to deal with vertically-integrated firms in the context of the RDR. The current UK "commission equivalent" regime which seeks to identify/disclose the benefits that in-house distribution arms receive from their product provider sister companies is often seen as both complex and confusing. However, it would appear to be a lot closer to what CESR is looking for than the FSA's RDR proposals where "commission equivalent" would effectively be replaced by a system where advice and product charges are separately disclosed.

Payments and non-monetary benefits authorised subject to certain cumulative conditions – Disclosure

Question XI: Do you have any comments on CESR's views about summary disclosures (including when they should be made)?

CESR's expectations as to the content, form and timing of firms' summary disclosures of inducements are far more detailed than anything contained in COBS 2.3 where COBS 2.3.2R just copies out the base Article 26 requirement. Amendment of COBS 2.3 to bring the FSA's requirements into line with CESR expectations would represent a major compliance change for APCIMS' firms.

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

While detailed disclosure of inducements only has to be provided upon a client's request, we are concerned that certain of CESR's expectations in this area may be impracticable. For example, paragraph 108 states that "detailed disclosure should not only mention all the types of third party payments and non-monetary benefits provided or received but should always provide the exact amount of the third party payments and non-monetary benefits". Because of the different payment schedules and conventions operated by the unit trust management companies, APCIMS' firms have never been able to quantify exactly the commission they receive. On NMBs, the situation is even harder, as in for example putting an exact value upon a piece of research received from an executing broker.

To date, certain FSA authorised and regulated business to business transactions have been obstructed due to disagreements on interpretations of the rules, which is disadvantageous for the industry, markets and clients alike. We believe this is an area where action is needed to ensure there is a common understanding amongst regulated firms. A practical example of the difficulties encountered by one of our members is attached as Appendix 1 to this document.

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

No.

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

We agree with CESR that there must not be a one-size-fits-all approach regarding disclosures and CESR believes that when choosing the documentation through which disclosures are made, investment firms should take into account elements such as the type(s) of service(s) provided to their clients or the way they provide services to clients. We are also very supportive of CESR's recommendation in Paragraph 123.

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

In its discussions with the FSA, APCIMS has emphasised that disclosure solutions developed for institutional fund managers are unlikely to be appropriate for APCIMS' members' business undertaken with private customers and small intermediate customers (e.g. small charities and trusts). It is therefore very important to differentiate along appropriate lines.

APCIMS, December 2009

Appendix 1: APCIMS response to CESR's Consultation Paper Inducements: Good and poor practices

APCIMS firm case study- example

In March/April 2008 we were proposing to provide discretionary investment management services to an FSA-regulated hedge fund manager which wanted us to manage a portion of one of its funds. We normally charge 1.5% management fee + 20% performance fee and the fund manager asked us to increase our charges to 2% management fee + 25% performance fee (charged to the fund) and then rebate the excess to the fund management company.

- (i) I could not see how this could be said to enhance the quality of the service to the client.
- (ii) I asked them to confirm that the arrangement was disclosed to the client. They said that it was, because the two directors of the fund company (paying the extra fees) were the same two individuals as the directors of the fund management company (receiving the rebate). They declined to explain how or whether the arrangement was disclosed to the investors in the fund and refused to provide a prospectus.

The fund manager's compliance officer insisted that this was fully in compliance with MiFID and that "everybody does it". They got very rude when I refused to do it and turned away their business. When I asked our lawyers for advice (expecting them to say "don't be silly, of course that's wrong"), they spent more than a month tying themselves in knots trying to conclude that it was OK, or would be if we could be satisfied about the disclosure issue.