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The Committee of European Securities Regulators Provides Guidance to Investment Firms on Proper Practices for Inducements

The Committee of European Securities Regulators (“CESR”) published on April 19 a report¹ reviewing the good and poor practices on inducements (or compensation) exhibited by more than 150 regulated European investment firms (the “Report”). The Report provides firms with a benchmark against current industry practices to measure their effectiveness in complying with the rules on inducements as stated in Article 19(1) of the Markets in Financial Instruments Directive (“MiFID”),² and in Article 26 of the MiFID implementing Directive 2006/73/EC (“Implementing Directive”).

CESR defines “good practices” as industry practices that CESR considers to be sensible actions for investment firms to follow. Although CESR endorses and encourages these practices, it recognizes that it is sometimes reasonable for different types of firms to follow different routes to comply with the same legal requirements. CESR uses the term “poor practices” to identify those industry practices that CESR considers to be imprudent actions for investment firms to follow.

1. Inducements

According to Article 26 of the Implementing Directive, investment firms can pay/provide (or be paid/provided) the following commissions, fees or non-monetary benefits in relation to the provision of an investment or ancillary service to a client:

- a) fees, commissions or non-monetary benefits paid by, or on behalf of, the client,
- b) payments and non-monetary benefits paid by, or on behalf of, a third party, provided that (i) the firm clearly discloses to its clients the nature and amount of the fee – or the method used to calculate the fee when the amount cannot be ascertained beforehand – prior to providing the service, and (ii) the payment or non-monetary benefit is designed to enhance the quality of the service and does not hinder the firm from acting in the client’s best interests, or
- c) fees that are “proper fees” and are necessary to provide investment services (for example, custody costs, settlement and exchange fees, regulatory levies or legal fees). “Proper fees” do not create conflicts with the firm’s duties to act honestly, fairly and professionally in accordance with the best interests of its clients.

¹ CESR/10-295, Inducements: Report on Good and Poor Practices.

² Directive 2004/39/EC.

2. CESR's Guidance on Inducements

After CESR released its initial recommendations on inducements in 2007,³ CESR published a consultation on October 14, 2009, seeking comments from investment firms on what they believe would constitute permissible payments under MiFID. From the responses to the consultation paper, CESR developed guidance, published in the Report and in a companion feedback statement on the responses released on the same date,⁴ to help firms understand the behavior that regulators encourage and discourage, including: (i) classifying payments and benefits and establishing an effective firm compliance policy, (ii) identifying proper fees, (iii) receiving fees that enhance client services and that are in the client's best interest, and (iv) disclosing to clients the fees received under the inducements rules. Also, CESR asked investment firms to provide their views as to the cross-border challenges they face as a result of Member States' implementation of the inducements rules.

(i) Classifying Payments and Creating an Effective Compliance Policy

The Report emphasizes that arrangements and procedures are essential in fulfilling investment firms' obligations under the MiFID inducements rules. However, the Report adds that firms "enjoy a certain degree of flexibility in the approach to be adopted according to the nature, scale and complexity of their business and the nature and range of investment services and activities undertaken in the course of that business."⁵

Regardless of the differences in firms' nature and size, CESR recommends that:

- Investment firms monitor and regularly assess their procedures' effectiveness and adequacy.

³ CESR/07-228b, Inducements Under MiFID and CESR/07-085, CESR's Level 3 Recommendations on the List of minimum records under Article 51(3) of the MiFID Implementing Directive.

⁴ CESR/10-296, Feedback Statement, Inducements: Good and Poor Practices.

⁵ CESR/10-295, Inducements: Report on Good and Poor Practices, at ¶ 9.

- A firm's senior management be involved directly in developing the procedures to comply with the Implementing Directive.
- Internal compliance procedures ensure that each payment or benefit is assessed for its compliance with the Implementing Directive prior to the firm receiving or providing that payment or benefit.

CESR suggested that a firm's approach to dealing with inducements can be included as an integral part of the firm's general conflicts of interest policy or in a separate policy on inducements.

The Report also states that effective procedures should work through the following process:

- **Identify** the relevant payments and benefits that occur for the firm.
- **Classify** the payments or benefits under Article 26 as either between the firm and the client (Article 26(a)) or between the firm and a third party (Article 26(b)). If a payment or non-monetary benefit is between a firm and a client, MiFID rules require no additional verification for compliance purposes.
- **Evaluate** whether, by its nature, the payment or non-monetary benefit between a firm and a third party is a payment necessary for providing services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees under Article 26(c) (*i.e.*, a proper fee). If not, evaluate whether the payment or benefit creates a conflict with the firm's duty to act in the client's best interests.
- **Arrange** that, once a payment or non-monetary benefit has been assessed as an inducement permitted under Article 26(b) or (c), the firm keeps complying with the Implementing Directive on a continuous basis.
- **Prevent** any payment or benefit that does not comply with the Implementing Directive from being made or received.

(ii) Acting in the Best Interest of the Client and Payments Designed to Enhance the Quality of the Service Provided to the Client

Article 26(b) requires that all payments and non-monetary benefits must be designed to enhance the quality of service to a client and to avoid impairing compliance with a firm's duty to act in the best interests of its clients.

To meet the "designed to enhance the quality of service" requirement, firms must provide an expected benefit to the relevant client when the firm is receiving a payment or non-monetary benefit. The Report states that firms should consider the following factors to determine if the payment or non-monetary benefit enhances the quality of the service to the client:

- the type of service provided,
- the expected benefits to the client and to the firm,
- whether there is an incentive likely to change the firm's proper behavior,
- the relationship between the firm and the entity involved with the benefit, and
- the nature of the item.

The Report notes situations where payments and non-monetary benefits can cause conflicts, including where investment firms that provide investment advice receive payments from product providers and where investment firms that provide portfolio management services receive payments from product providers or firms executing orders. According to CESR, conflicts arise in these situations because the firm has more influence over the service the client receives than when it provides services such as the transmission of orders.

Respondents cited a number of ways they manage potential conflicts of interest, including:

- passing to clients the rebates received from third parties,
- negotiating the same level of rebates without regard to the promoter,

- implementing information walls to prevent "leaks" of information about the payments received to the departments that provide the service to the client so that advisors, sales staff and portfolio managers in contact with clients do not have access to information about the agreed rebates, and
- using a best execution policy to ensure brokers are chosen on the basis of their execution services and not the quality of the research they provide.

Respondents also claimed several reasons why third-party payments or non-monetary benefits enhanced the quality of services provided to clients, but CESR found some to be unacceptable, including:

- Payments that cover costs that would otherwise be charged to the client. "The client is likely to end up paying the costs no matter how they are charged, directly or indirectly."⁶
- Rewarding a firm's sales force by emphasizing some financial products over other comparable products that receive less lucrative payments.
- Investment firms receiving payments for services when the business volumes sent to firms executing client orders reach certain thresholds.
- Rewarding an investment firm's advisers and sales staff for the levels of commissions generated by the sales they make to clients.

The Report found that firms were uncertain about the "designed to enhance" language of the rules, noting that firms focus on actual enhancement and that there does not appear to be a common approach amongst investment firms in determining when it is acceptable to provide or receive third-party or non-monetary benefits. Stating that the "designed to" language implies a wider focus, CESR re-emphasizes that such assessment should be made at the time the arrangement is proposed rather than after a payment.

⁶ CESR/10-295, Inducements: Report on Good and Poor Practices, at ¶ 82.

(iii) Proper Fees

Article 26(c) of the Implementing Directive permits “proper fees which enable or are necessary for the provision of investment services” and that “by their nature cannot give rise to conflicts with the firm’s duty to act honestly, fairly and professionally in accordance with the best interests of the client.”

Such fees include:

- custody costs,
- settlement and exchange fees,
- regulatory levies, or
- legal fees.

Though recognizing that the category of proper fees is intended to be narrow, the Report states that “proper fees” also can include:

- fees paid by a firm to access and operate on a given execution venue,
- custody-related fees in connection with corporate events, including shareholders’ meetings or dividend distributions, and
- additional items required to provide services to the client, including payments to information providers and consultants for services related to the provision of the investment or ancillary service, such as tax advice to an intermediary about a placement it will manage.

The Report states that, in general, a fee only can be proper if the investment firm is *paying* it to the third party rather than if the firm is *receiving* it from the third party. “Otherwise it would be difficult for the nature of the payment (received by the investment firm), to meet the requirement of the absence of any potential conflict with the best interests of the client.”⁷

- However, the Report notes that some payments by the investment firm could give rise to conflicts of interest even if the payment would qualify, on its face, as a proper fee. For example, the following payments could give rise

to a conflict of interest: rebates that an investment firm receives in connection with payments, such as to access and operate on a given execution venue, and the venue rebates money if a certain volume threshold is reached,

- underwriting fees where the investment firm participating in the underwriting also sells the financial instruments issued to investors,
- compensation to tied agents by an investment firm (as these are deemed an internal payment within the firm),
- intra-group payments, as the Report noted that these were not “proper fees” and that payments made between distinct legal entities belonging to the same group are to be treated in the same way as payments outside the group, and
- payments by an investment firm to an introducing broker.

3. Proper Disclosure of Inducements

While Article 26 of the Implementing Directive permits firms to disclose only the “essential terms of the arrangements” in the form of a summary disclosure, the Report states that such a disclosure must provide adequate information to the client to enable him (i) to relate the disclosure to the particular investment or ancillary service that is provided to him, or to the relevant products, (ii) to make an informed decision whether to proceed with the investment or ancillary service, and (iii) to decide whether to ask for the full information.

To meet these requirements, the Report recommends that firms’ disclosure be proper in content, method and timing:

- **Content.** The disclosure should include:
 - The exact amount of the third-party payments and non-monetary benefits provided or received in relation to the service or services to be provided to the client.
 - The types of third parties from which the firm receives or to which it provides payments or non-monetary benefits.

⁷ CESR/10-295, Inducements: Report on Good and Poor Practices, at ¶ 45.

- When service is provided prior to payment, a “reasonable band range” of the payments along with “the method of calculating the amount.”
- When the exact amount of payments or the method of calculating the amount varies depending on (i) the class of instrument, firms should provide the information per service provided and per class of instrument, or (ii) the provider of the financial instruments, the firm should identify any material differences.
- If a summary disclosure, notice that the investment firm receives research from brokers that receive from the firm orders for execution, and, if a detailed disclosure, further detail including an estimate of the value of the investment research.
- A statement that the client can request more detailed information and to whom such a request can be directed.
- **Method.** According to the Report, the disclosure should be:
 - Clear, fair and not misleading regarding third-party payments and non-monetary benefits.
 - Easily accessible and in a user-friendly format.
 - Clear regarding the minimum and maximum levels of third-party payments. CESR advises that when firms in practice receive between specific minimum and maximum levels of payments, that they disclose those amounts rather than just disclose the maximum of the range.

- **Timing.** The disclosure should be sent to clients with enough time to provide them sufficient opportunity to decide whether they will proceed with the investment or request more information.

4. Cross-Border Compliance with Inducement Rules

The Report states that, while the majority of respondents did not need to adopt new procedures across Member States to comply with the inducements rules, some internationally active groups that operate subsidiaries across Europe were affected. The Report adds that while those firms had to supplement their procedures across Member States, the existing differences between the Member States’ implementations of the inducements rules were not significant barriers to those firms’ engagement in cross-border activities. Nevertheless, the Report cites the response of one firm, which stated that “the line taken on an acceptable summary disclosure, types of payment and remuneration structures differs between Member States making it difficult to achieve a convergent application of the MiFID inducements rules.”⁸ For example, it noted that at least two Member States have rules limiting the payments received by investment firms providing portfolio management services from firms executing client orders.⁹ The Report notes that such situations illustrate a need for firms to have a better understanding of the application of the inducements rules.

⁸ CESR/10-295, Inducements: Report on Good and Poor Practices, at ¶ 45.

⁹ CESR/10-295, Inducements: Report on Good and Poor Practices, at ¶ 136.

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