MiFID II

Inducements

December 2016
**Key Points**

- There will be further guidance on the meaning of the phrase "designed to enhance the quality of the service" (which is a pre-requisite for an inducement to be permitted under MiFID).
- There will be new disclosure requirements for those inducements that are permitted. The changes will be relatively minor, but they do include an ongoing obligation to notify clients of commissions received as a result of an ongoing service.
- The inducements rules will be applied in relation to the receipt of investment research. This is likely to herald a new regime relating to dealing commission and the means by which firms pay brokers for investment research. In particular, there are likely to be detailed rules relating to the operation of "research pools", which many firms currently use to pay for investment research.
- For firms that give independent advice and portfolio managers, there will be new rules which will in effect ban them from receiving fees, commissions and monetary or non-monetary benefits from third parties in relation to the investment services they provide to clients.

- the payment must be "designed to enhance the quality of the relevant service to the client" and not impair compliance with the firm's duty to act in the best interests of the client.

Under MiFID II, there are likely to be significant changes in relation to inducements. There will be two main areas of change:

- new guidance, which will be relevant to all firms; and
- new rules for independent advisers and portfolio managers only.

Each of these topics is considered further below.

**New guidance for all firms**

"Designed to enhance the quality of the service"

The current version of MiFID provides that the payment of an inducement must be:

- designed to enhance the quality of the relevant service to the client; and
- not impair compliance with the firm’s duty to act in the best interests of the client.

Although these requirements have always been part of MiFID, the Commission and ESMA have been concerned that firms have not been having sufficient regard to them in practice. As a result, although the concept will remain the same as part of MiFID II, there will be additional guidance on when the quality enhancement test is satisfied, which in practice is likely to mean that the range of inducements that will be permitted under MiFID II is likely to be narrower than is currently reflected in market practice.

The MiFID II Delegated Directive\(^1\) states that an inducement shall be considered to be designed to

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\(^1\) Commission Delegated Directive (EU) of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any
enhance the quality of the relevant service to the client if all of the following conditions are met:

(a) the inducement is justified by the provision of an additional or higher level service to the relevant client, proportional to the level of inducement received, such as:

(i) the provision of non-independent advice on, and access to, a wide range of suitable financial instruments including an appropriate number of instruments from third party product providers having no close links with the firm;

(ii) the provision of non-independent advice combined with either an offer to provide ongoing advice to the client (at least annually) or another ongoing service that is likely to be of value to the client (e.g. advice about asset allocation);

(iii) the provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the target market, including an appropriate number of instruments from third party product providers having no close links with the firm, together with the provision of either

1. added-value tools (e.g. objective information tools helping the relevant client to take investment decisions or enabling the client to monitor, model and adjust the range of financial instruments in which they have invested); or

2. periodic reports of the performance and costs and charges associated with the financial instruments;

(b) the inducement does not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client; and

(c) it is justified by the provision of an ongoing benefit to the relevant client.

Recitals to the Delegated Directive make clear that this is intended to be a non-exhaustive list. That is to say, an inducement will be permitted if it fulfils all of the above conditions, but is not necessarily prohibited if it does not. However, the FCA has proposed draft rules which treat this list as exhaustive, so that inducements will only be permitted where all of the above requirements are met.

In addition to the above tests, an inducement will be acceptable only if all relevant services are provided to the clients without bias or distortion as a result of the inducement being received.

Once firms have fulfilled the quality enhancement criterion, they should maintain the enhanced level of quality.

As part of their organisational requirements, firms will need to able to clearly demonstrate that any inducements are designed to enhance the quality of the service to the client, such as:

- keeping an internal list of all inducements accepted by the firm from a third party; and

- recording how the inducements enhance the quality of the services provided to the clients and the steps taken in order not to impair the firm’s duty to act honestly, fairly and professionally in accordance with the best interest of the client.

Permitted inducements: disclosure requirements

In relation to those inducements which are permitted, firms will be required to disclose the following information to clients:

- prior to providing the service: the firm must disclose the existence, nature and

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monetary or non-monetary benefits (the “MiFID II Delegated Directive”).

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2 See draft rule COBs 2.3AR(1) in Appendix 1 to FCA, Markets in Financial Instruments Directive II Implementation – Consultation Paper III (CP16/29).
amount of the inducement received or paid, and where the amount of payments cannot be ascertained, the method of calculation should be disclosed. The existing MiFID I provisions already provide for this, but the Delegated Directive provides additional guidance to the effect that:

- minor non-monetary benefits should only be described in a generic way; and
- other non-monetary benefits should be priced and disclosed separately;

- after providing the service: where the firm is unable to ascertain the amount of an inducement received or paid prior to providing the service, and instead discloses the method of calculating that amount, it must provide information of the exact amount of the inducement received or paid after the event; and

- at least once a year, as long as (on-going) inducements are received by the firm in relation to its services, the firm should inform its clients on an individual basis about the actual amounts received or paid. Minor non-monetary benefits may be described in a generic way.

When a number of entities are involved in the distribution channel, each firm that is providing an investment or ancillary service must make the appropriate disclosures.

Investment research and dealing commission

During the ESMA consultation process, there was some debate about whether the receipt of investment research to portfolio managers actually constituted a form of inducement. Many firms still have arrangements under which they receive investment research from third party brokers and research houses and pay for that research from their clients’ holdings. The Commission and ESMA are evidently concerned about the potential for this to give rise to conflicts with the duty of firms to act in the best interests of their clients.

It is now clear that provision of investment research is capable of being an inducement. The Delegated Directive provides additional clarity for Member States around what they should and should not treat an inducement.

The Delegated Directive requires Member States to ensure that the provision of research by third parties to firms providing portfolio management (or other investment or ancillary services) to clients will not be regarded as an inducement if it is received in return for:

- direct payments by the firm out of its own resources, or
- payments from a separate research payment account controlled by the firm, provided that certain conditions are met (see below).

Many investment managers currently operate "research pools", under which they gather together money that has been taken from clients for the purpose of paying for investment research, from which payments are made to the providers of that research (often on the basis of a vote among staff at the investment manager, based on whose research has proved useful). The MiFID II requirements contemplate that such arrangements can continue, but there will be additional restrictions in place:

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<th>Conditions for research accounts</th>
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<td>(a) The account may only be funded by a specific &quot;research charge&quot; to the client. The specific research charge must:</td>
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<td>(i) only be based on a &quot;research budget&quot; set by the firm for the purpose of establishing the need for third party research in respect of investment services rendered to its clients</td>
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<td>(ii) not be linked to the volume and/or value of transactions executed on behalf of the clients.</td>
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<td>(b) The total amount of research charges received in the research payment</td>
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account may not exceed the research budget.

(c) The firm must agree with each client the research charge as budgeted by the firm and the frequency with which the specific research charge will be paid by the client over the year.

(d) The firm may only increase the research budget after clear information about the intended increase has been provided to client.

(e) If there is a surplus in the research payment account at the end of a period, the firm should have a process to rebate those funds to the client or to offset it against the research budget and charge calculated for the following period.

(f) As part of establishing a research payment account and agreeing a reasonable charge with their client, the firm must set and regularly assess a research budget as an internal administrative measure.

(g) The allocation of the research budget to purchase third party research should be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm’s clients. Such controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria referred to in paragraph (j) below.

(h) Firms may not use the research budget and research payment account to fund internal research.

(i) The firm is responsible for operating the research payment account, but it may delegate the administration of the research payment account to a third party, subject to certain requirements.

(j) The firm should regularly assess the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions.

(k) Firms should be able to demonstrate the elements in paragraph (j) in a written policy and provide it to their clients. It should also address the extent to which research purchased through the research payment account may benefit clients’ portfolios (including, where relevant, by taking into account investment strategies applicable to various types of portfolios) and the approach the firm will take to allocate such costs as fairly as practicable to the various clients’ portfolios.

(l) Where a firm makes use of the research payment account, it should provide the following disclosure to its clients:

(i) Prior to providing the service: In line with Article 24(4)(c) of the MiFID II Directive, clients should be informed about the budgeted amount for research and the amount of the expected research charge for each of them. This information is further elaborated in the ESMA technical advice on information on costs and charges.

(ii) After providing the service: In line with Article 24(4)(c) of the MiFID II Directive clients should receive annual information on the total costs that each of them has incurred for third party research. The firm should also, upon request by their clients or regulators, provide a summary of the providers who were paid from this account, the total amount they were paid over a defined period, the goods and services received by the firm, and how the total amount spent from the account compares to the budget set by the firm for that period (noting any rebate or carry-over if residual funds remain in the account).
Firms providing execution services should identify separate charge for these services that only reflect the cost of executing the transaction (buying or selling a financial instrument). Any other goods or services rendered should be subject to a separately identifiable charge; the supply of these goods or services should not be influenced by (or be conditional on) levels of payment for execution services.

In the course of its consultation on the Technical Advice\(^3\), ESMA noted that the regulatory framework under the UCITS Directive and the Alternative Investment Fund Managers ("AIFM") Directive have been built on the MiFID framework in many respects, including inducements. ESMA remarked that it would be appropriate for the Commission to extend the MiFID II requirements in relation to the UCITS and AIFM Directives.

**New requirements for independent advisers and portfolio managers**

Under MiFID II, there are new significant requirements for (i) firms who give independent advice and (ii) portfolio managers:

**Restrictions on fees, commission and benefits from third parties**

Independent advisers and portfolio managers must not accept and retain fees, commissions and any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of services for clients.

In relation to fees, commissions and monetary benefits, the Delegated Directive requires Member States to ensure that:

- firms can only accept third party payments if they pass them on in full to the clients;
- firms will have to establish a policy for the allocation and transfer of third party payments to clients; and
- firms will have to inform clients of the total amount of third party payments received and passed on to the client, for instance through the regular periodic reporting statements provided to the client.

**Minor non-monetary benefits**

Independent advisers and portfolio managers will not be able to receive any non-monetary benefits, with the exception of "acceptable minor non-monetary benefits", which must be:

- information or documentation relating to a financial instrument or investment service, whether generic or personalised to an individual client’s circumstances,
- issuer-sponsored written material from a third party, provided that the fact that the issuer has paid for the material to be produced is clearly disclosed in the material and such material is made available at the same time to any investment firms wishing to receive it, or to the general public.
- participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service;
- hospitality of a reasonable de minimis value (e.g. food and drink during a business meeting or a conference, seminar or other training events); and
- other minor non-monetary benefits that a Member State deems capable of enhancing the quality of service provided to a client and that are of a scale (having regard to the total level of benefits provided by one entity or group) are of a scale and nature that are unlikely to impair compliance with an investment firm’s duty to act in the best interest of the client.

Acceptable minor non-monetary benefits must be reasonable and proportionate and of such a scale that they are unlikely to influence the recipient’s

\(^3\) ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "Technical Advice"), Chapter 2.15
behaviour in any way that is detrimental to the interests of the client.

Where minor non-monetary benefits are permitted, they must be disclosed to clients before the provision of services to the client. They may, however, be described in a generic way.

Although the list above is intended to be exhaustive, ESMA indicated during consultations that it might also be supplemented through guidelines issued by ESMA.

The ban on commissions, etc. for independent investment advisers and portfolio managers will cover similar areas to that which was covered in the UK by the Retail Distribution Review ("RDR"), which came into effect at the end of 2012. Even for firms which are subject to the RDR rules, however, there will be some important differences.

- The new restriction will apply to discretionary managers when acting on behalf of their clients. The RDR rules currently apply only to advisers and do not apply directly to a discretionary manager (except insofar as the manager is giving advice rather than managing).

- The RDR rules only apply in relation to retail clients. The MiFID II rules will apply to professional clients as well as retail clients.

- The new restrictions will apply to all financial instruments that are within the scope of MiFID. This means that it will apply for the first time to certain types of instrument that are not currently within the scope of the RDR, such as shares and debentures.

By implication, investment firms which are not independent advisers or portfolio managers will continue to be permitted to receive non-monetary benefits which are not minor. In relation to such firms, the inducements rules from MiFID I will continue to apply.

Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive and the Delegated Directive into national law.

The changes to the MiFID Implementing Directive will be made by way of the MiFID II Delegated Regulation which will become effective by 3 January 2018. The MiFID II Delegated Regulation will have direct effect and the member states will not need to implement these changes into national law.