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**By Paul Foley**
*Partner*
*McKeever Rowan*

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*e: pfoley@mckr.ie*

# MiFID DEVELOPMENTS AUTUMN 2010

Embedded in MiFID are a number of provisions entitling the **European Commission** to review aspects of MiFID in light of market developments and results from the operation of MiFID in the member states. At the end of July of this year, CESR published their technical advice and recommendations to the Commission, (i) on **Equity Markets**, (ii) **Non-Equity Markets Transparency** (iii) **Transaction Reporting** (iv) **Investor Protection and Intermediaries** and (v) in response to Commission requests for additional information. Additionally the Commission has now published proposals for a pan European regulation of **short selling**.

Collectively these papers and proposals call for a wide range of reforms to bolster transparency in Europe's increasingly fragmented equities market and over the counter derivatives market. Importantly if taken forward by the Commission, they would impact many elements of securities market regulation and constitute a major change in the EU regulatory landscape.

**Set out below is a summary of the Commission short selling proposals and of the technical advice provided by the CESR to the Commission.**

**Short Selling and CDS Regulation – the Commission proposed new regime**

At the height of the financial crisis in September '08 several member states and the US adopted emergency measures to restrict or **ban short selling** in some or all securities. They acted due to concerns, at a time of considerable financial instability, that **short selling** may aggravate the downward spiral in the prices of shares, notably in financial institutions in a way which could ultimately threaten their viability and create system risks. Because of a lack of a harmonised framework, member states took different approaches to the problems created by short selling.

Additionally earlier in 2010, concerns were expressed by some member states about the possible role played by derivatives notably **credit default swaps** in relation to the prices for Greek sovereign bonds. A number of member states have recently adopted temporary or permanent restrictions at national level relating to short selling of shares and/ or **credit default swaps**. Under a **credit default swap**, one party pays a fee to another party in return for compensation or a payment in the event of a default by a reference entity.

Short selling a financial instrument can be carried out wherever that instrument is listed, or over the counter; even in markets other than the primary market of the issuer concerned. Moreover many markets are by their nature cross border or international and accordingly there is a real risk of national responses to short selling and credit default swaps being circumvented or ineffective in the absence of EU level action. Hence the Commission proposals, which are summarised below.

1. **Shares, sovereign debts and CDS.** A person (natural or legal ) who has a **net short position**[1] in relation to issued shares will be required to **disclose to the public** details of the position whenever the position reaches or falls below a **relevant publication threshold** being an amount that **equals 0.5%** of the value of the issued share capital of the company and **each 0.1% above** that.

   Additionally, a natural or legal person who has any of the following positions will be required to notify the **relevant competent authority** whenever any such position reaches or falls below a **relevant notification threshold** for the member state concerned (a) **a net short position** related to the **issued sovereign debt** of a member state or of the union (b) an uncovered position in a **credit default swap** relating to an obligation of a member state or of the union. The **relevant notification thresholds** shall consist of an initial amount and then additional incremental levels in relation to each member state and the union as specified in measures taken by the Commission.

[1] The proposals require that short positions should be subtracted (or 'netted off') from long positions, as notification of a net short position provides more meaningful information to regulators and/or the market.

2. **Marking orders as short**. Additionally **all share orders** on trading venues **will require to be marked as 'short'** by persons **executing orders** if they involve a **short sale**, so that regulators can obtain additional information about short selling volumes. The trading venue would publish **daily a summary** of the volume of orders **marked as short orders**.

3. **Sovereign bonds**. A specific regime for **notification to regulators only** of **significant net short positions** in EU sovereign bonds is proposed. This would also include notification of **significant credit default swap positions** relating to **sovereign debt issuers**.

   The transparency regimes for EU shares and EU sovereign bonds would also cover the **use of derivatives to obtain a net short position relating to the shares or bonds.**

4. **Powers proposed for regulators in exceptional situations**. In exceptional situations, competent authorities (i.e. financial regulators) will have powers to impose **temporary measures** such as to require **further transparency** or **to restrict short selling in shares and in credit default swap transactions**. These powers would extend to a wide range of instruments.

   The powers of intervention only contemplate **temporary action (for up to a three month period)**. A temporary measure could be extended for further periods not exceeding three months at a time, but this will have to be fully justified. To ensure a consistent approach, the Commission is given the power to **further define criteria for determining when an exceptional situation arises**.

   Competent authorities are also given the power in the **case of a significant fall in the price of a financial instrument** or class of financial instruments to **impose a very short restriction on short selling** of the financial instrument.

5. **Obligations of short traders and trading venues – prevention of naked short selling**

   The proposal requires that in **order to enter a short sale**, an investor must have borrowed the instruments concerned, or entered into an agreement to borrow them, or have an arrangement with a third party whereby that third party has acquired that the share or sovereign debt instrument has been located and reserved for lending for the person so that settlement can be effected when it is due. **This is known as a 'locate rule'.**

   To deter settlement failures, trading venues will be required to ensure that there are adequate arrangements in place for **buy in** of shares or **sovereign debt** where there is a settlement failure, as well as for fines and a prohibition on short selling for late settlement. This approach addresses the risks of settlement failure while taking into account existing best practice in many markets, which is for firms to locate shares for borrowing prior to executing a short sale order.

6. **Enforcement powers for regulators are proposed**

   The proposal provides for competent authorities to have all the powers necessary. As certain measures may involve monitoring or enforcement against persons outside the European Union, EU regulators are required to reach cooperation agreements with regulators in third countries where EU shares or sovereign bonds and associated derivatives are traded.

7. **Exemptions proposed – Primary Market Operations and ex EU trading venues**

   Exemptions are proposed for market making activities, for **primary market operations** and for shares whose principal market **is outside the EU**. Market making includes providing price quotes for financial instruments to provide liquidity to the market or to fulfil client orders. **Market making activities are exempt because they play an important role in providing liquidity, and restricting their ability to short sell would have a significant adverse effect on the liquidity of markets.**

**Primary market operations** are transactions performed by dealers to provide liquidity to issuers of sovereign debt and for the purposes of stabilisation schemes (i.e. share issues intended to stabilise a share price) under the Market Abuse Directive.

A further exemption is proposed where the principal trading venue for the trading of the shares **is located in a country outside the EU.**

8. **Ban on naked CDS**

A "naked CDS" refers to the situation where the CDS is used by the buyer not to hedge a risk but to take a position (take risk). The seller of the CDS would gain if the credit risk did not materialise; whereas the buyer of the CDS would gain if the price of the CDS subsequently increases due to a perception by the market of an increased risk of default of the issuer.

The proposal does not provide for a permanent **ban on naked CDS** as the Commission considers that this would be disproportionate, as it could negatively affect the liquidity of sovereign debt markets. However, the proposals do provide for (a) greater transparency so that persons with significant naked CDS positions relating to sovereign debt issuers must notify regulators of their positions (b) powers for regulators to obtain information in individual cases about CDS transactions and (c) powers of intervention in an exceptional situation for a competent authority to temporarily prohibit or restrict the use of CDS. Such measures would be temporary in nature and subject to coordination by ESMA.

9. **Proposed timing for adoption of a legislative proposal?**

The proposal now passes to the European Parliament and the Council for adoption. Once adopted the regulation would apply from 1 July 2012. In the context of the proposal to revise the **Markets in Financial Instruments Directive** (MiFID), due in the first quarter of 2011, the Commission will consider options including transaction reporting, position reporting and the possibility of position limits, which could complement the short selling proposals.

Finally, In the context of the proposal to revise the **Market Abuse Directive**, due in the first quarter of 2011, the Commission will consider extending the **prohibition of market manipulation** to **all over the counter instruments, including derivatives**: such action could impact the prices of financial instruments affected.

I) **CESR Technical advice on equity markets**

**Improving the pre trade transparency regime for RMs/MTFs - IOIs**

CESR recommends that MiFID be amended to clarify that **actionable indications of interest ( IOIs)** are considered to be **orders** and as such subject to **pre-trade transparency requirements**. An IOI is the name commonly used to refer to a **message sent between investment firms** to convey information about available trading interest. IOIs are also used by dark pools to attract order flow and to maximise trading opportunities by enabling investments to find the contra side of orders. The information provided in an IOI can include the symbol of the security, the side (ie. buy or sell) and volume/price of trading interest.

**Systematic Internalisers**

MiFID defines an SI as an investment firm which on an **organised, frequent and systematic basis**[2] deals on own account by executing client orders outside an RM or MTF.

The core of the MiFID requirement is that a systematic internaliser ("SI") is required to publish firm quotes in shares that are **classified as liquid** under MiFID when dealing in sizes up to **standard market size**. To date only a small number of firms have informed their home state regulators that they carry out systematic internalisation.

[2] A firm is an SI, if (a) the activity has a material commercial role for the firm and is carried out in accordance with **non discretionary rules and procedures**; (b) the activity is carried on by personnel or by means of an automated technical system assigned to that purpose, irrespective of whether those personnel or that system are used exclusively for that purpose, (c) the activity is available to clients on a regular or continuous basis. Article 21 of the MiFID Regulation.

CESR recommends a broader review of the SI regime as part of the MiFID review. CESR also recommend (a) that the reference to **non-discretionary rules** in art 21 of the MiFID Reg be amended to reflect the guidance provided in **recital 15 of the Regulation**;[3] (b) that SIs be required (i) to maintain **two sided quotes** (as opposed to the one sided currently, which tell the market little about the size of business they are prepared to take on) (ii) to maintain a **minimum quote size** equivalent to 10% of the **standard market size of any liquid share** in which they are a systematic internaliser and (iii) the provision exempting SIs from individually identifying themselves in post-trade reports, if they publish quarterly trading data should be retained and (iv) periodic trading data reports for SIs making use of the exemption described at (iii) be required on a more frequent basis.

**Enhancing the Quality of Post Trade Information and APAs**

CESR recommends introducing formal measures to improve the **quality of post trade data**[4], shorten **delays for regular and deferred publication**[5] and to reduce the complexity of the regime. As a supplement to the introduction of new standards on **data quality** and **guidelines on trade publication**, CESR recommends requiring investment firms to publish their trades through **Approved Publication Arrangements (APAs)**.

All **APAs** would be required to operate data publication arrangements to prescribed standards as set out in Annex 1 of the advice, including for example have appropriate systems and controls to identify incomplete or erroneous information received from investment firms and regulatory reporting requirements.

**Extending the transparency obligations to equity like instruments**

CESR recommends extending the **MiFID transparency regime** to **equity like instruments** admitted to trading on an RM including **depositary receipts, exchanged traded funds** and **certificates**. These instruments are considered to be equity like, since they are traded like shares and from an economic point of view equivalent to shares.

The proposed regime should apply to organised trading platforms (RMs and MTFs) with respect to the non-equity instruments traded on these platforms.

**Setting standards for execution quality data and production of reports on execution quality**

Under MIFID, firms are required to review on a regular basis, the **venues they use to execute orders** and to consider whether they need to **make changes** to those execution arrangements. This assessment would require they **obtain data on execution performance** for each of the venues, over a period of time.

The issue is whether or not a regulatory intervention is required to ensure that investment firms have the necessary information to select appropriate execution venues to include in their execution plans.

CESR discusses two main policy options being (i) that the CESR would define key metrics for execution quality data for voluntary use by execution venues and data vendors; and (ii) execution venues would be required to produce periodic reports on execution quality using these metrics. CESR recommend that the obligation on execution venues might start by applying to regulated markets, MTS and SIs and only apply to liquid shares; and with publication being required on a quarterly basis.

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[3] **Recital 15** provides that an activity should be considered as **having a material commercial role** for an investment firm if the activity is a **significant source of revenue**, or a **significant source of cost**. An assessment of significance for these purposes should in every case take into account the extent to which the activity is conducted or organised separately, the monetary value of the activity and its comparative significance by reference both to the overall business of the firm and to its overall activity in the market for the share concerned in which the firm operates. It should be possible to consider an activity to be a significant source of revenue for a firm even if only one or two of the factors mentioned is relevant in as particular case.

[4] CESR recommends amending MIFID and the MiFID Regulation to a) Embed standards aimed at improving clarify, comparability and reliability of post trade transparency that would cover matters such as condition codes for trade types and process for correcting erroneous post trade reports and (b) provide greater clarity in terms of i) what constitutes a single transaction for post trade transparency purposes and ii) which investment firm shall make information related to OTC transactions public.

[5] For example, MiFID requires transactions be published as close to real time as possible but no later than 3 minutes after the trading time. CESR recommends that the deadline for the reporting of these transactions should be reduced from **3 minutes to 1 minute**. CESR recommends maintaining the existing deferred publication framework ( table 4 of annex II of the Regulations) which currently encompass four liquidity bands but that delays and thresholds be recalibrated so as to (i) ensure that almost all transactions are published **no later than the end of the trading day** with only the very largest trades that occur later in the trading day publishing prior to the opening of the trading day on the next trading day (ii) shorten the **intra day delay of 180 minutes to 120 minutes** and (iii) raise all intra day transaction size thresholds.

**Establishing a new regulatory regime for broker crossing systems (BCS)**

A number of investment firms in the EU operate systems that **match client order flows internally**. Generally these firms receive orders electronically, **utilise algorithms to determine how they should best be executed** (given a client's objectives) and then pass the **business through an internal system** that will attempt to find matches.

Investment firms operating these systems are subject to client orientated conduct of business rules, including best execution, rather than the market orientated rules designed for RMs and MTFs. CESR recommends that a new regulatory regime for **investment firms operating such systems**. This would include notification by investment firms that they **operate a BCS**, publication **of a list of BCSs**, a requirement for a **generic BCS identifier** in **post trade transparency information**, publication of **aggregate trade information** at the level of each **BCS** at the end of the day and **identification of BCS** in **transaction reports**.

CESR also recommend that a **limit is imposed** on the amount of business that can be executed by **BCSs** before they are required to become an MTF.

**Addressing certain options and discretions in MiFID**

CESR recommends retaining the discretion regarding the use of **pre-trade transparency waivers** and maintaining the role of CESR/ESMA in considering the use of waivers to ensure their consistent and reasonable use.

However CESR recommends converting the member state discretion under article 22(2) of MiFID into a rule by prescribing that investment firms comply with their obligation to make an **unexecuted client limit order** immediately public by transmitting it to a pre trade transparent RM/MTF.

**High Frequency trading**

CESR consider that further scoping work is necessary to (i) better understand **high frequency trading strategies**[6] and the risks that they pose to the orderly functioning of markets and (ii) develop some specific guidelines on the application of appropriate systems and controls for investment firms and trading platforms in a **highly automated trading environment** (eg. volatility measures / circuit breakers for trading platforms in the context of pan European trading).

CESR also recommended that further work be done (including consultation with industry) to develop **specific guidelines on sponsored access**. This work should identify the risks from naked access and focus on pre and post trade controls, outsourcing arrangements and consider the implications for both investment firms and trading platforms.

**II) Technical advice on non-equity markets transparency**

CESR has advised for a mandatory EEA **post-trade transparency** regime covering **corporate bonds**, **structured finance products** and **credit derivatives**.

CESR also indicated that there is currently an uneven playing field in the EEA in respect of the provision of **pre-trade transparency information** for **financial instruments other than shares**. CESR therefore recommends that given their growing importance that a compulsory harmonised pre trade transparency regime be introduced. The regime should apply to organised trading platforms with respect to the **non-equity instruments** traded on these platforms.

**III) Technical Advice on Transaction Reporting**

The key purpose behind the CESR recommendations below is to improve market supervision and ensure greater market integrity.

[6] Algorithmic trading (where orders are generated according to pre-set programmes and are not dependent on manual intervention) has become an increasingly significant proportion of overall volume. High frequency traders have also become important providers of continuous two way liquidity in electronic order books, acting in some respects as quails market makers. High frequency trading is now estimated to account for between a third and half of equity trading volume within the EU. The time taken to execute orders has become a critical factor for such trading strategies as systems seek to take advantage of arbitrage opportunities of extremely short duration or to react instantaneously to changes in trading patterns or market developments,. Hence there has been a technological arms race to reduce the time between which an order is generated and when it is executed on the order book (known as latency). Whereas trading times used to be measured in seconds, they have now fallen to milliseconds and are coming down to micro seconds.

**Introducing a third trading capacity (client facilitation)**

CESR identified three possible scenarios where an investment firm executes a transaction (i) it acts on its own account and on its own behalf (pure principal transaction) ie on the decision of the firm; (ii) it acts for the account and on behalf of a client (pure agency transaction); and (iii) **it acts on its own account and on behalf of a client ie. on the order of the client.** The third scenario makes supervision of these trades difficult since they are currently reported in many countries as **principal trades while their nature is closer to an agency** trade since the initiative to trade and the corresponding order comes from a client of the firm.

CESR has recommended a modified proposal following criticism of its first proposal (moving away from their first proposal of riskless principal) by **introducing a client facilitation capacity**.

**The current principal trading capacity would be split into principal as part of a client facilitation and principal for own account (proprietary)**. The requirement would be for two transaction reports from the investment firm for client facilitation trades, one showing the market side transaction and the second showing the client side transaction with both having as trading capacity, principal as part of a client facilitation.

**Requiring the collection of and defining standards for client and counterparty identifiers**

Article 13 of the MiFID Regulation and its Annex 1 set out the content of the **transaction reports** that investment firms which execute transactions in financial instruments admitted to trading on a regulated market have to report to their competent authorities.

However the same article gives member states the possibility to, require transaction reports to identify the clients on whose behalf the investment firm has executed the transaction. **Reporting of client identifiers is not compulsory under MIFID.**

CESR has now recommended that the Commission amend MiFID and its Regulation to **make the collection of client ID mandatory to all competent authorities**. This they argue will provide a significant contribution in improving the ability to investigate cases of **market abuse**.

**Requiring the collection of client ID when orders are transmitted for execution**

CESR also recommends amending MIFID to enable competent authorities to require the **reporting of client ID** when orders are transmitted for execution with the transmitting firm, either providing **the client ID to the receiving firm** or reporting the transaction, including **full client ID** to the competent authority.

**Extending transaction reporting obligations to market members not authorised as investment firms**

CESR suggests amending MiFID by introducing a **transaction reporting obligation** applicable to regulated markets and MTFs that admit as members undertaking **currently falling under the article 2 (1)(d) exemption** for all the transactions carried out by these members on the respective regulated market or MTF. **This exemption would mean that transactions made on their own account by non authorised firms would now fall within the scope of transaction reporting obligations.**

**IV) Technical advice on Investor protection and intermediaries**

**Recording of telephone conversations and electronic communications.**

Currently MiFID does not mandate that **investment firms record orders received and or transmitted and or executed over the telephone or though electronic communications**. Individual member states may impose such a requirement, but they are not obliged to do so, under MiFID. CESR believes that there should be a common minimum EEA regime for the recording of orders received or transmitted by telephone or through electronic communications. Such a regime would be an important step forward in terms

of certainty, consumer protection and surveillance of markets to achieve a credible deterrence.

**Accordingly CESR has recommended that a minimum harmonising recording requirement be adopted by regulators**. The CESR advice lists what should be recorded, which is slightly wider that the services listed immediately above. The records of such recordings CESR recommend be kept in accordance with MiFID for 5 years and they should be stored in a way that makes them accessible by Regulators and prevents them from being altered.

**Requiring trading venues to produce reports demonstrating execution quality**

CESR proposes the introduction of a general obligation in MIFID for execution venues to produce **regular reports on the quality of execution in shares**. This would be supported by **clarification of the existing obligations on investment firms executing** orders in shares to collect information to enable them to assess which execution venues should be included in their execution policies, in particular in regard to investment firms executing orders on behalf of retail clients.

**Clarifying the distinction between MIFID complex and non complex financial instruments**

Under MIFID an **execution only service** without or without ancillary services can only be provided on instruments classified as **non-complex** and provided that certain conditions are complied with, including, such service is provided **at the initiative of the client** and the client is warned that the firm has not assessed suitability or appropriateness.

CESR also notes that a strict application of this would permit a firm to provide the ancillary service of **granting loans to an investor** where the firm granting the loan is involved in the transaction in conjunction with the execution and/ or the reception and transmission of client orders, **without the need for an appropriateness test**.

CESR recommend that if a firm is **offering this ancillary service i**n conjunction **with the execution** and / or the reception and transmission of client orders it should always be required to establish whether the client has the **necessary knowledge and experience to understand the risks**, regardless of whether the financial instrument concerned is **complex or non-complex**.

CESR also recommend that Article 19(6) of MiFID be updated so that execution only services without determining appropriateness may not be effected in the case of (i) shares in **non-UCITS collective investment** undertakings and **shares that embed a derivative** (ii) bonds that **embed a derivative** or incorporate **a structure** which makes it difficult for the client to understand the risk involved (iii) money market instruments or forms of securitised debt that **incorporate or embed a derivative** or a structure that makes it difficult for the client to understand the risk.

**Clarifying the scope of the definition of investment advice**

CESR is concerned that the current wording of article **52 of the level 2 directive could be misunderstood** as excluding from the definition of investment advice, personal recommendations which are issued exclusively through distribution channels. CESR proposes clarifying that investment advice can be provided through distribution channels (such as the internet) and accordingly the client protection rules would apply (including the requirement to assess suitability). As such CESR proposes a revised definition of investment advice to address this.

**Harmonising the rules for the supervision of tied agents and related issues**

MiFID **permits member states** to allow investment firms authorised in their jurisdiction to **appoint tied agents**. The vast majority of member states allow firms to appoint and use tied agents. CESR believes that this discretion should be **transformed into a rule** requiring member states to permit investment firms appoint tied agents.

CESR also recommends that member states be required to prohibit tied agents registered in their territory **from handling client's money and financial instruments**.

Tied agents will have to be **registered in the public register** in the member state where they are established. Member states will be required to establish a public register for tied agents established in their territory. Members states shall be required to ensure **that tied agents are only admitted to the public register if it has been established that they are of sufficiently good repute** and that they possess appropriate general commercial and professional knowledge so as to be able to communicate accurately all relevant information regarding the proposed service to the client or potential client.

Member states may decide that investment firms can verify whether the tied agents which they have appointed are of sufficiently good repute and possess the knowledge as referred to in the third subparagraph.

**Responses to Commission's request for additional information in relation to the MiFID review**

**The Execution Only Regime**

CESR considers that it should be made clear that even under the **execution only regime**, firms must comply with the applicable conduct of business rules (such as the Article 19(1) obligation to act honestly, fairly and professionally) and the Article 19(3) obligation to provide **appropriate information** to clients to help them take investment decisions on an informed basis).

CESR also recommends that the article 19(6) words **"provided at the initiate of the client where execution only services are provided on non-complex financial instruments"** could do with clarification. **Recital 30 of MiFID provides some guidance on this where it provides:**

*"A service should be considered to be provided at the initiative of a client unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients."*

**Disclosure for OTC Derivatives**

Recital 44 of the MiFID Level 2 Directive refers to the right of a professional client to ask for information from investment firms and the obligation on investment firms to respond to reasonable and proportional requests for information. As a result of the financial crisis, CESR believes that there is a case **for strengthening investor's rights to request information**, where they **trade OTC Derivatives and** other complex or tailor made products. CESR thinks it worth exploring the strengthening of the right to request information in the following two areas:- **first prior to the transaction, a risk scheme profile in different market conditions and second, independent quarterly valuations of such complex products.**

**Specific Organisational Requirements relating to the Launch of New Services or Products**

CESR believes that under MiFID, firms should be required to have specific organisational requirements to ensure that for **new products and services**: (a) an assessment is made of the compatibility of the product or services with the characteristics and needs of the clients; (b) the compliance function has the responsibility for ensuring procedures and measures are in place to ensure the product complies with applicable rules including those **related to suitability/ appropriateness** etc. and that the firm has policies and procedures in place to ensure that the risk of the new products are adequately managed (c) where appropriate, products and services are stress tested to identify how they might perform in a range of market environments.

Firms should review the **distribution and performance of products** to ensure that performance correspond with what was originally envisaged in terms of the performance of the product. Information about products and services should be inside the scope of the compliance reports to management under Article 9(2) of the Level 2 Directive.

**Disclosures of Commissions**

Article 19(1) of MiFID requires investment firms when providing investment services to act honestly, fairly and professionally in accordance with the best interests of its clients. Article 26 of the MiFID level 2 directive titled **"Inducements"** sets out the requirements for the receipt or provision by an investment firm of a **fee, commission** or non-monetary benefit.[7]

CESR has noticed that the **disclosure requirements**, especially those in relation to **inducements** made or received in connection with the distribution of financial instruments are not applied uniformly. More especially, the content of the disclosures varies from firm to firm. MiFID does not require any **ex post facto reporting** while it appears that in practice, it is not always possible to disclose **a priori** the exact amount of inducements.

Investment firms have **considerable discretion as to how they make disclosures about inducements.** As a result they are not well integrated without a product or service information.

The CESR has observed that the **enhancement condition** (Article 26(b)(ii)) appears to be difficult to handle and assess. It requires a subjective assessment and thus has been interpreted differently by firms sometimes creating an unlevel playing field.

**The UK** has developed rules which will allow for investment firms providing investment advice to be **continue to be paid by a rebate from the commission**, the client pays to a product provider **but prevent the product provider from setting the amount of the rebate which would have to be agreed between the client and the adviser**.

The **risk is highest when the firm provides portfolio management** due to the fact that the portfolio manager may take a decision for the client without prior consent from the client. It is thus hard to imagine how a firm providing a portfolio management service for example can receive inducements from a third party without impairing its duty to act in the exclusive interest of its client.

Taking into account these elements, the CESR members wonder whether **inducements should be forbidden when portfolio management services are being provided**.

Recital 39[8] of the Level 2 Directive provides wide protection for investment advisers when receiving payments from product providers. The fact that some firms tend not to understand properly the distinction between the enhancement condition and the best interest of the client condition contributes to the difficulties surrounding the application of these conditions.

***Paul Foley, Partner, McKeever Rowan***
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[7] The firm is not to be regarded as acting honestly, fairly and professionally in accordance with the best interests of a client, if in relation to the provision of an investment or ancillary service to the client, the firms pays or is paid any fee or commission or provides or is provided with any non monetary benefit other than the following: (a) a fee, commission or non monetary benefit paid or provided to or by the client or a person on behalf of the client; (b) a fee, commission or non monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied: (i) the existence nature and amount of the fee, commission or benefit or where the amount cannot be ascertained, the method of calculating that amount is clearly disclosed to the client in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service; **(ii) the payment of the fee or commission or the provision of the non monetary benefit:**
**(I) is designed to enhance the quality of the relevant service to the client; and**
**(II) does not impair compliance with the firm's duty to act in the best interests of the client;**
(c) proper fees which: (i)enable or are necessary for the provision of investment services such as custody costs, settlement and exchange fees, regulatory levies or legal fees and (ii) by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients. For the purposes of paragraph (1)(b)(i) an investment firm, may disclose the essential terms of the arrangements relating to the fee, commission or non monetary benefit in summary form, if the firm (a)undertakes to disclose further details of the request of the client, and (b) honours that undertaking.

[8] 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 ore commendations **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**.