INDUCEMENTS: THE LUXEMBOURG PERSPECTIVE FROM MIFID I TO MIFID II

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I. Introduction

The subject of inducements is of particular importance for Luxembourg as it directly impacts two major segments of its financial services sector: the investment fund industry which focuses on crossborder distribution and the private banking activity which concentrates on wealth management.

In both areas it is customary for firms which provide investment services to clients (whether it be order execution, investment advisory or portfolio management services in respect of financial instruments) to receive or provide fees, commissions or other non-monetary benefits (together referred to as "Inducements") from the product manufacturer, its representative or other professionals in the chain. The advice/sale channel and the related remuneration structure constitute the main source of conflict of interest risk for retail investors.(1)

With the implementation of MiFID I(2) and MiFID I Implementing Directive(3) into Luxembourg legislation in 2007, specific requirements were set in relation to the receipt or payment of any such Inducements associated with the sale, advice or management of an investment product in order to make sure that these Inducements do not place the firm in a situation where it would not comply with the basic rule of conduct to act honestly, fairly and professionally in accordance with the best interests of its clients. With the introduction of MiFID II(4), the European legislator has reinforced the requirements by imposing *inter alia* a total prohibition on Inducements for independent advisers and discretionary portfolio managers.

The objective of this article is to explain the existing legal regime under MiFID I in Luxembourg (which will continue to apply although with a narrower scope and a more stringent interpretation under MiFID II) and to set out what main changes are to be expected under MiFID II. It will briefly discuss the interaction of MiFID I/MiFID II with parallel legislation covering UCITS management companies, AIFM and the insurance sector.

II. The relevant Luxembourg legislation

When implementing MiFID I and MiFID I Implementing Directive, the Luxembourg legislator almost used the European texts word for word. Article 19(1) of MiFID I which sets out the overall rule of conduct requiring investment firms "to act honestly, fairly and professionally in accordance with the best interests of their clients [...]" has been introduced in identical terms in Article 37-3(1) of the Luxembourg law of 5 April 1993 on the financial sector as amended (the "Financial Sector Law"), safe that it is specified that the obligations apply to both banks and investment firms. The same is true for Article 26 of the MiFID I Implementing Directive which is replicated almost word for word in Article 30 of the Grand-Ducal Regulation of 13th July 2007 relating to organisational requirements and rules of conduct in the financial sector (the "MiFID I Regulation"). Article 30 of the MiFID I Regulation introduces the concept of Inducements into Luxembourg law and sets out the requirements in relation to the receipt or payment by an investment firm or a bank of a fee, commission or non-monetary benefit that could, in certain circumstances, place the firm in a situation of a conflict of interests.

In parallel, the supervisory authority (CSSF)(5) issued a circular on 31st July 2007(6) setting out explanations and giving specifications on certain aspects of the MiFID I legislation in particular with respect to Inducements(7) ("CSSF MiFID I Circular"). Attached to the CSSF MiFID I Circular are the CESR Recommendations on Inducements under MiFID(8) which are to be used by professionals in Luxembourg as a reference when applying the rules on Inducements.

Other relevant documents under Luxembourg law with respect to Inducement rules are the Luxembourg bank association's (ABBL) MiFID handbook of September

1. N. MOLONEY, *EU Securities and Financial Markets Regulation*, 3rd edition, Oxford EU Law Library, p. 808.
2. Directive 2004/39/EC of 21 April 2004, *O.J.E.U.* L 145, 30 April 2004.
3. Directive 2006/73/EC of 10 August 2006, *O.J.E.U.* L 241, 2 September 2006.
4. Directive 2014/65/EU of 15 May 2014, *O.J.E.U.* L 173, 12 June 2014.
5. Commission for the Supervision of the Financial Sector.
6. CSSF Circular 07/307 as amended by circulars CSSF 13/560, CSSF 13/567 and CSSF 14/585.
7. CSSF Circular 07/307, Chapter 8 Inducements.
8. CESR, Inducements under MiFID – Recommendations, CESR/07-228b, May 2007.

2007[9] as well as an informal memorandum issued by an ABBL MiFID working group setting out a common view of the professional community on certain aspects of Inducements such as the conditions relating to service enhancement or the disclosure rule for clients. Further CESR documents, in particular the CESR report on good and poor practices in respect of Inducements,[10] ought to be considered by professionals in Luxembourg as part of the application of the Inducement rules.

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III. Two "narrow" categories of authorised Inducements

Article 30 of the MiFID I Regulation identifies two situations where banks and investment firms can pay/provide or be paid/provided Inducements in relation to the provision of an investment or ancillary service to a client without having to fulfil any further condition and without any specific disclosure requirement: (i) payments paid or provided to or by the client (Article 30(a) MiFID I Regulation) and (ii) proper fees which enable or are necessary to provide the service (Article 30(c) MiFID I Regulation). These two categories of Inducements are intended to apply only in a limited number of situations and constitute exemptions from the "general" regime on Inducements referred to below.

Article 30(a) only applies when the firm's invoice is paid directly by the client or when the client provides separate specific instruction to a person to make the payment on his behalf (e.g. an accountant or a lawyer) who then acts as a mere conduit for payments between the firm and the client.[11] The fact that the economic cost of payments is borne by the client alone is not sufficient for it to be considered to be made on behalf of the client.[12]

Although the list of items falling under the definition of "proper fees" provided in Article 30(c)[13] is not exhaustive, the scope of this article is limited by the condition that such fees may not, by their nature, conflict with the firms' duty to act in the client's best interest.[14] This test needs to be focused on the "nature" of the Inducements and not on the basis of whether the payment gives rise to such a conflict. Generally speaking, all kinds of fees paid by a firm in order to access and operate on a given instruction venue should normally fall within Article 30(c) (within the general category of settlement and exchange fees) as well as specific types of custody-related fees such as those paid by the investment firm in connection with specific corporate events.[15] However, despite calls from the Luxembourg industry to CESR[16] which were not accepted, standard commissions or fees, such as retrocessions of commissions or trailer fees to a distributor of financial products, are of the nature to potentially give rise to conflicts with the duty owed to clients, even if this remunerates legitimately services allowing clients to have access to products.[17] All these types of remuneration will therefore be part of the general Inducement regime referred to below.

MiFID II broadly follows the MiFID I template with respect to payments provided to or by clients or on their behalf and payment of proper fees as set out herein. The regime as described above should therefore continue unchanged under MiFID II.

IV. All other Inducements authorised subject to conditions only

Article 30(b) of the MiFID I Regulation governs the largest category of Inducements under MiFID I, namely all other payments related to the provision of an investment or ancillary service to a client, which have to meet certain conditions in order to be acceptable: quality enhancement, absence of conflict of inte-

9. Handbook on MiFID Issued by the Association des Banques et Banquiers à Luxembourg (ABBL).
10. CESR, Inducements: Report on good and poor practices, CESR/10-295, 19 April 2010.
11. E.g. a client has agreed with the firm A the fee that he will pay to A; the client could, if he wishes in connection with the service provided by A, also provide an explicit instruction to C to pay the amounts that the client owes to A out of the client's account with C; the client is able to instruct C to cease to make such payments (CESR, Inducements under MiFID – Recommendations, CESR/07-228b, May 2007, p. 12).
12. Circular CSSF 07/307, p. 20.
13. Custody costs, settlement and exchange fees, regulatory levies and legal and judicial fees.
14. Circular CSSF 07/307, p. 20.
15. CESR, Inducements: Report on good and poor practices, CESR/10-295, 19 April 2010, p. 15.
16. Which in the meantime has been replaced by the ESMA.
17. Circular CSSF 07/307, p. 20.

rest and disclosure. This category has a large scope and includes all types of Inducements including standard fees[18] regardless of their purpose and also cover intra-group payments[19] and not only payments in an open architecture structure.

A. Quality enhancement and absence of conflict of interest

The first condition is that the payments must be designed to enhance the quality of the relevant services and must not impair compliance with the firm's duty to act in the client's best interests. From a wording point of view it is interesting to note that the Luxembourg text of Article 30(b) refers to the Inducement which "must be designed to enhance the quality of the relevant service" ("*doit viser à améliorer la qualité du service fourni*") and reflects the English text of the MiFID I Implementing Directive. The French text of the Directive does not contain the words "designed to" ("*viser à*") and hence appears stricter than the English text.

The term "designed" makes clear that the judgment has to be made at the time the payment arrangement is proposed, rather than only once the payment has been made.[20] This condition does not imply that the quality of the service must be enhanced for each client. The assessment may be performed at the level of the service offered to a group of clients, rather than for each service provided to each individual client.[21]

In principle, CESR agrees that Inducements paid to third parties which imply the provision of additional or higher services, or even offer access to a wider range of financial instruments are authorised if all other elements of the rules are complied with. CESR obviously specifies that this test must be assessed on a case-by-case basis having regard to its recommendations.[22]

In respect of distributions of units in Undertakings for Collective Investment (UCI), the informal memorandum of the ABBL referred to above gives important input on the commonly applied standards in Luxembourg. When distributing financial instruments in an "execution only" context where the firm is not receiving a specific remuneration from the client for an advisory service, the enhancement of the quality of the service is sufficiently evidenced through the fact that clients benefit from a broader, more diversified range of investments[23] and have access to up-to-date information in this respect. Where a firm also provides investment advice or portfolio management services (which increases the risk of non-compliance with its duty to act in accordance with the best interest of the client). Inducements can still be acceptable provided that the firm is able to demonstrate that such Inducements allow it to enhance the quality of its service in a manner which exceeds the quality of the advisory/ management service without payment or receipt of the Inducements. This would be the case if the firm maintained a dedicated infrastructure and extensive monitoring as management tool intended to optimize investor satisfaction and help to strengthen and enhance the quality of the advisory/ management service rendered to the client.[24] It is the expertise and know-how which ultimately benefit the clients and may justify Inducements subject to objective criteria.

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Irrespective of a sale or advice service, a firm or bank sometimes remunerates certain third parties for example in order to expand its client base (*apporteur d'affaires*). Such third parties fulfil a selection role vis-à-vis the client on behalf of which they act. The service enhancement may consist in a better selection of the financial institutions which offer the service which best corresponds to the client's expectations and requirements. Vis-à-vis the bank, these third parties introduce clients which fall within the relevant bank's defined target range. The remuneration could be a one off payment or a payment staggered over time.

Other type of Inducements which are identified by CESR as "good practice" as enhancing the quality of the service may consist of soft commissions (e.g. research, technical and IT facilities) received by firms providing portfolio management or advisory services from a custodian where their clients have deposited their assets and which also act as executing broker. This is in particular the case when such IT facilities

18. See above.
19. Circular CSSF 07/307, p. 20.
20. CESR, Inducements under MiFID – Recommendations, CESR/07-228b, May 2007, number 15, p. 8.
21. Circular CSSF 07/307, p. 21.
22. CESR, Inducements: Report on good and poor practices, CESR/10-295, 19 April 2010, p. 22.
23. Circular CSSF 07/307, p. 21.
24. Informal ABBL MiFID working group paper, October 2007.

enable access to real time information on the assets of the firm's clients.[25]

B. Disclosure

Article 30(b) of MiFID I Regulation further requires that the existence, nature and amount of the payment or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, prior to the provision of the relevant service.

By virtue of the final paragraph of Article 30, firms may disclose in a summary form only the essential terms of the arrangements relating to the payments, provided that further details are disclosed at the request of the client and the client is informed of his right to ask for such details. A generic disclosure merely referring to the fact that the investment firm may or will receive Inducements is not considered as sufficient.[26] The Luxembourg regulator has indicated that a disclosure without any reference value on the amount of the Inducements would not be acceptable. The summary disclosure should thus be specific to the service provided and contain sufficient information to enable the client to make an informed decision.

Where a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients.[27]

V. A reduced scope of the "Authorised Inducements subject to conditions" under MiFID II

With the introduction of MiFID II, the above regime remains applicable (although in a narrower way (see below)) but possibly with a few nuances due to ESMA's proposal,[28] in the context of the MiFID II level 2 measures[29] to expand the obligations of quality enhancement and disclosure by specifying these criteria. In respect of the quality enhancement condition, ESMA has suggested to the EU Commission the introduction of a non-exhaustive list of circumstances and situations to be considered by the national competent authorities when assessing whether or not the condition is met. The Inducements would not generally be regarded as designed to enhance the quality of the relevant service in any of the following cases:

- the payment is not justified by the provision of an additional or higher level service to the client, proportional to the level of Inducements received. ESMA gives three examples[30] of situations where the provision of an additional or higher level service is demonstrated:
  - the provision of non-independent advice and access to a wide range of suitable financial instruments including an appropriate number of instruments from third party product providers;
  - the provision of non-independent advice combined with either an offer to the client, at least on an annual basis, to assess the continuing suitability of the financial instruments in which the client has invested or with another ongoing service that is likely to be of value to the client;
  - the provision of access to a wide range of financial instruments at a competitive price, that are likely to meet the needs of the target market, including an appropriate number of instruments from third party product providers together with either the provision of added-value tools (e.g. objective online information tools), or providing periodic reports on the performance, costs and charges associated with the financial instruments;
- the payment directly benefits the recipient firm, its shareholders or employees without tangible benefit to its end user client;
- in relation to an on-going Inducement, the payment is not related to the provision of an on-going service to an end user client.

Additional requirements also need to be met, notably in terms of organisational requirements.

Firms should be able to demonstrate clearly that any Inducements paid or received by the firm are designed to enhance the quality of the service to the client, such as:

- keeping an internal list of all Inducements accepted from a third party in relation to the provision of investment or ancillary services,
- recording how it uses or intends to use these Inducements to enhance the quality of services provided to its clients and the steps taken in order not to breach the firm's duty to act honestly, fairly and professionally in accordance with the best interest of the client.

25. CESR, Inducements: Report on good and poor practices, CESR/10-295, 19 April 2010, p. 23.
26. CESR, Inducements: Report on good and poor practices, CESR/10-295, 19 April 2010, p. 26.
27. CESR, Inducements under MiFID – Recommendations, CESR/07-228b, May 2007, p. 11.
28. This proposal has been issued to and remains to be confirmed by EU Commission.
29. See EU Commission's request to ESMA on technical advice regarding possible delegated acts and implementing acts concerning MiFID II Directive (EU/2014/65) and the MiFID II Regulation (EU) 600/2014 on markets in financial instruments, p. 26 and the ESMA Final Report on Technical Advice to the Commission on MiFID II and MiFIR (ESMA /2014/1569), 19 December 2014.
30. See ESMA Final Report on Technical Advice to the Commission on MiFID II and MiFIR (ESMA /2014/1569), 19 December 2014.

Dossier

MiFID II no longer provides for the possibility of a summarised disclosure as is currently the case under MiFID I. ESMA recommends that the firm should disclose the nature and amount of the payment or non-monetary benefit concerned on an *ex-ante* basis, prior to the provision of the relevant investment or ancillary service. Where the amount of payments cannot be ascertained, the method of calculating that amount must be clearly disclosed to the client. Only minor non-monetary benefits can be described in a generic way. In the case where an investment firm was unable to ascertain on an *ex-ante* basis the amount of any payment or benefit it was to receive, it must disclose the exact amount received on an ex-post basis. In addition, the investment firm would be required to inform its clients at least once a year about the actual amount of payments received.

VI. A ban on Inducements for discretionary portfolio managers and independent advisers under MiFID II

Transparency and disclosure alone are sometimes not sufficient. For that reason, MiFID II opts for a more radical solution and introduces a prohibition on Inducements received[31] by portfolio managers and independent advisers except for minor non-monetary benefits. Firms which provide investment advice on an independent basis and/or which provide portfolio management services will not be permitted in the future to accept and retain payments made by third parties in connection with the provision of their services. If payments are made by a third party, they must be transferred as soon as possible to the client.[32]

The currently proposed MiFID II Level 2 measures contemplate that:[33]

- the Inducements should be passed on as soon as possible to the client but no specific timeframe would be set as the fees can be received at various points in time and for several clients at once;
- the firms will have to set up a policy to ensure the correct allocation and transfer of third party payments to each individual client; and
- the clients should be informed of the amounts transferred to them through regular bank account statements.

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Each investment firm will be required to inform its clients whether it provides investment advice on an independent basis or not. In order to be able to declare that investment advice is provided on an independent basis, firms will have to define and implement a selection process to assess and compare a sufficient range of financial instruments available on the market.[34] Not all firms will be able to include all elements which are necessary to satisfy the condition of the selection process for the assessment and comparison of a sufficiently wide range of financial instruments. These firms will have to hold themselves out as non-independent and will be subject to the conditional Inducement regime already existing under MiFID I but with a number of strengthening elements referred to above.

Minor non-monetary benefits are not covered by this prohibition provided that they are clearly disclosed to the client, they are capable of enhancing the quality of the service provided and they are of a scale and nature such that they could not be deemed to impair the ability to act in the client's best interests. These benefits may be restricted to generic information relating to a product or service, participation in conferences, seminars and other trainee events on the benefits of a particular product or service and hospitality for a reasonable *de minimis* value (such as food and drink during a business meeting).

31. The regime of "Inducements authorised but subject to conditions" as previously described is maintained for fees, commissions or non-monetary benefits paid by an investment firm in connection with the provision of portfolio management or independent advice services.
32. Recital (74) of MiFID II specifies that the payments may not be deducted from the fees payable by the client in relation to the service provided (no offset allowed).
33. "The legitimacy of inducements to be paid to/by a third person", in *ESMA Final Report on Technical Advice to the Commission on MiFID II and MiFIR (ESMA/2014/1569)*, 19 December 2014, p. 138.
34. Article 24.7(a) MiFID II. These financial instruments must not be limited to financial instruments issued or provided by the investment firm itself or by entities having close links or by other entities having with which the investment firm has such close legal or economic relationships, as to pose a risk of impairing the independent basis of the advice provided. See also the ESMA Final Report on Technical Advice to the Commission on MiFID II and MiFIR (ESMA /2014/1569), 19 December 2014.

VII. Interaction between MiFID I/MiFID II and parallel legislation on insurance companies, UCITS management companies or AIFMs

In Luxembourg, the MiFID I regime is applicable to banks and to investment firms. Insurance companies or intermediaries (i.e. agents and brokers), when distributing insurance based investment products and in particular unit linked life insurance products, are currently not subject to a specific regime on Inducements. This is likely to change with MiFID II which sets out the overall principle that investment products based on insurance should be subject to appropriate requirements similar to those set out in MiFID II not only to guarantee a protection to retail clients in all circumstances but also to create a level playing field between similar products. The rules on distribution of insurance products are currently being reformed through the Insurance Mediation Directive II Reform[35] and discussions are going on at the level of the European Council and of the European Parliament.

An alignment is also expected in relation to UCITS management companies and authorised AIFMs,[36] as – in substance and under the current UCITS Directive[37] and AIFM Directive[38] regimes – inducement rules similar to those under MiFID I (but not MiFID II) apply (i) to authorised AIFMs when providing investment management, administration and marketing services to AIFs, and (ii) to UCITS management companies when providing investment management and administration (not marketing) services to UCITS. MiFID rules on Inducements (currently those of MiFID I and, once transposed, those of MiFID II) automatically apply to UCITS management companies and AIFMs providing MiFID services pursuant to the "ancillary services exception" of Article 6(3) of the UCITS Directive and Article 6(4) of the AIFM Directive, respectively.

35. Proposal for a Directive of the European Parliament and of the Council on insurance mediation.

36. In this respect, please refer to paragraph 24 on page 132 of the aforementioned ESMA Final Report on Technical Advice to the Commission on MiFID II and MiFIR (ESMA/2014/1569).

37. Directive 2009/65/EC of 13 July 2009, *O.J.E.U.* L 302, 17 November 2009.

38. Directive 2011/61/EU of 8 June 2011, *O.J.E.U.* L 174, 1 July 2011.