European Commission Delegated Directive on the rules applicable for inducements. May 2016.

On 7 April 2016 the European Commission (EC) published the Delegated Directive supplementing *Directive 2014/65/EU* on markets in financial instruments[1] (MiFID 2), with regards to the rules applicable to the provision or reception of inducements[2] by or from an investment firm when providing investment services. This Directive, which also contains provisions with regard to safeguarding of financial instruments and funds belonging to clients, and product governance obligations, was the first Level 2 measure adopted by the EC in implementation of the Level 1 Directive, although time remains for the European Parliament or Council to file objections[3].

Article 24 (7) to (9) of MiFID 2 introduces further restrictions, in addition to those in MiFID 1, on investment firms (IFs) providing or receiving inducements, considering that the current regime fails to meet the stated aims of strengthening investor protection and increasing transparency in the provision of services to clients.

In relation with inducements, the most important new measure brought in by MiFID 2 is the **prohibition on IFs accepting or retaining third party-inducements** when providing **financial advice on an independent basis or portfolio management services**. In these cases, the IFs must pass on the whole value of any such inducements to clients. But the applicable rules do allow an exemption in the sense that IFs can accept and retain **"minor non-monetary benefits"**, an exhaustive list of which is given in the Delegated Directive.

MiFID 2 also still **permits IFs to pay or receive inducements** linked to investment or ancillary services provided to or by a third party where these **enhance the quality of the service** to the client and do not impair compliance with the **firm's duty to act** honestly, fairly and professionally **in the best interest of the client.**

Finally, the Delegated Directive sets out the circumstances in which **preparation of financial research** linked to trade execution by third parties for IFs does not count as inducements.

The EC Delegated Directive considers three distinct cases:

1) **Inducements regime when providing investment advice on an independent basis or portfolio management services**. (*Art. 12 of the delegated Directive)*.

Article 12 of the Delegated Directive states that **whenever IFs receive inducements** from third parties in respect of investment advice on an independent basis[4] or portfolio management, **they must transfer the whole of their value to clients** as soon as possible. For this purpose, the rule obliges IFs to set up and implement a policy that assures amounts received are allocated individually and transferred to each client. IFs also have to disclose to clients any inducements transferred, in their regular reports for instance.

However, the IFs **can accept non-monetary benefits provided these qualify as minor**. Such benefits must be reasonable, proportionate, enhance service quality and of such a scale that they are unlikely to influence the IF’s behaviour in any way that is detrimental to the interests of the relevant clients. Specifically, article 12 gives the following exhaustive list of the minor non-monetary benefits which are acceptable: i) information or documentation relating to a financial instrument or an investment service; ii) written material from a third party that is paid for by a corporate issuer on a new issuance provided that such material is available at the same time to any IF wishing to receive it or to the general public; iii) participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service; iv) hospitality of a reasonable de minimis value, such as food and drink during a business meeting or a conference, seminar or other training events; and v) other minor non-monetary benefits which a Member State deems capable of enhancing service quality having regard to the total level of benefits provided by one entity or group of entities are of a scale and nature that are unlikely to impair compliance with an IF’s duty to act in the best interests of the client.

The client must be informed, before the service is provided, of the minor non-monetary benefits although these can be described in a generic way.

2) **Inducements regime when providing services other than investment advice on an independent basis or portfolio management services.** *(Art. 11 of the Delegated Directive)*.

IFs can pay or receive fees, commissions or non-monetary benefits when an investment service, or an ancillary service, is provided to or by a third party, if these amounts are *designed to enhance the quality of the service* offered and *do not impair the IF’s compliance with its duty to act* honestly, fairly and professionally *in the best interests of the client.* Specifically, article 11 of this delegated Directive sets the conditions for such **enhanced service quality** as follows:

.- an additional or higher level service is provided, proportional to the level of inducements received. The article gives a non-exhaustive list of situations which can be considered an additional or higher level service. These are: i) provision of non-independent investment advice on and access to a wide range of suitable financial instruments, including third-party instruments from providers having no close links with the IF; ii) provision of non-independent investment advice combined with other ongoing services which are unaffected by the receipt of the inducement: assessment, at least annually, of the continuing suitability of the financial instruments in which the client has invested, or another ongoing service that is likely to be of value to the client such as advice about optimal asset allocation; and iii) provision of access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the client, including an appropriate number of instruments from third-party providers having no close links with the IF, together with either the provision of added-value tools, such as objective information tools helping the client to take investment decisions or enabling them to monitor, model and adjust the range of financial instruments in which they have invested, or providing periodic reports of the performance and costs associated with the financial instruments.

.- it does not directly benefit the recipient firm, its shareholders or employees without tangible benefit to the relevant client.

.- it is justified by the provision of an ongoing benefit to the relevant client in relation to an ongoing inducement.

Inducements can never be considered acceptable if the service provided is in some way biased or distorted as a result of the inducement.

IFs also have to provide the following information on inducements: i) the amount of the inducement, prior to provision of the service, including non-monetary benefits whose amounts must be separately identified (minor non-monetary benefits can be described generically); ii) when the amount of the inducement is not known prior to provision of the service but the calculation method is, the exact ex-post amount; and iii) the actual amount of inducements, at least annually, separately identified, where ongoing inducements are received (minor non-monetary benefits can be described in a generic way).

3) **Inducements in relation to third-party research to IFs.** (*Art. 13 of the delegated Directive*).

The **provision of research** by third parties to IFs, usually in connection with portfolio management or investment advice services by the brokers through which they execute trades, **counts as non-monetary inducements**. In practice, investors pay indirectly for these reports through brokerage fees, which cover both the cost of research and the cost of the broker's transaction. The legislator has not considered this payment as a minor non-monetary inducement as it could give rise to a conflict of interest.

Notwithstanding the above, article 13 of the Directive d**oes not consider receiving research to be an inducement if the third-party providers receive specific payments**, from either the IF's own resources or from a research payment account. Any such account must be funded from specific research charges, which cannot be linked to the volume or amount of the trades. The IF will be responsible for operating the account although it may delegate its administration to a third party and agree with each client the amount and frequency of research charges.

IFs that use a research payment account must provide individual information to their clients in advance (individual budgets and estimates) and ex-post (annual disclosure of the total cost of third-party research).

For greater control, IFs have to draw a budget for research payments as an internal administrative measure which must be based on a reasonable assessment of the need for third-party research. Also, IF cannot use a specific research payment account or the abovementioned budget to fund their internal research. Finally, to ensure that money spent buying in research is spent in the best interests of the client, IFs must prepare a written policy and provide it to their clients, which will allow them to periodically assess the quality of the research purchased and indicate how far they may benefit clients' portfolios, including, where relevant, taking into account investment strategies applicable to various types of portfolios, and the approach the firm takes to allocate such costs fairly to the various clients' portfolios.

Links:Directive implementing Directive 2014/65/EU on inducements

1) Directive 2014/65/EU of the European Parliament and Council, of 15 May 2014, on markets in financial instruments, amending Directive 2002/92/EC and Directive 2011/61/EU. Level 1 regulation.

2) Inducements are defined as fees, commissions or monetary or non-monetary benefits charged or paid by investment firms to third parties, or a person acting on behalf of a third party, in relation with the provision of an investment or ancillary service to clients.

3)The remaining draft MiFID 2/MiFIR delegated acts are due to be published in the next three months.

4) MiFID 2 clarifies that investment advice services should only be deemed independent if the IFs meet the following requirements: i) does not accept or retain inducements from third parties in relation with the service provided; and ii) before making a recommendation should previously assess a sufficient range of products from different providers.