



## ADVICE TO ESMA

### Advice on Guidelines on remuneration policies and practices (MiFID)

---

#### I. Executive summary

- The Stakeholder Group (SMSG) strongly supports the adoption of the draft Guidelines on remuneration policies and practices and the overall approach of ESMA with respect to the Guidelines. The SMSG is of the view that the content of the Guidelines is excellent. The Guidelines constitute a timely development as there have been many cases of mis-selling across Europe in the last decade, ranging from pensions to mortgages to investment products which have impacted in particular on retail investors. A key factor identified as a driver for the promotion, recommendation and selling of unsuitable products is the presence of financial incentive schemes for sales staff which are not necessarily aligned to the clients' best interests. Some regulators have addressed the issue recently, such as the Financial Services Authority (FSA) in the United Kingdom and the *Autorité des Marchés Financiers* (AMF) in France. However, ESMA intervention is justified to raise standards across Europe, to promote best practices, to achieve stronger compliance with the harmonized MiFID regime, and to promote stronger convergence in supervisors' approaches in this area. The Group is also of the view that ESMA's intervention in an area of critical importance for investor protection highlights the importance of investor protection in the post financial crisis regulatory and supervisory environment.
- The adoption of these Guidelines should contribute effectively to enhancing consumer protection, which is one of the ESMA's objectives. In addition, adopting these Guidelines should contribute to a sound, effective and consistent level of regulation and supervision as it will enhance and harmonise the level of protection in the single market. Currently the issue of remuneration policies and practices in the financial sector is dealt with through articles 13(3) and 18 of the Markets in Financial Instruments Directive (MiFID) and Articles 21, 22 and 23 of the MiFID Implementing Directive which set out the obligations on firms in respect of conflicts of interest. Article 19 of MiFID sets out the conduct of business obligations of firms when providing investment and/or ancillary services. The cornerstone Article 19(1) obligation requires firms to act in the best interests of their clients and to treat them fairly; this provision has important implications for how remuneration schemes are designed. However, those provisions leave ample room for diverging practices at national level. Evidence gathered from ESMA's July 2011 remuneration questionnaire to supervisors indicated the divergent ways in which firms determine how to address conflicts of interest and conduct of business risks arising from their remuneration policies and practices. The issue of remuneration is also dealt with by CEBS „Guidelines on remuneration policies and practices“ but mainly from a prudential perspective. Therefore, there is a need for clarification by ESMA and the setting of a minimum standard.

- While overall approving of both the timing and the content of the Guidelines, which cover, in its opinion, all relevant aspects of this issue, the SMSG would like to make some supporting comments and point to some issues related to investor protection.
  - The SMSG would like to mention that the issue of mis-selling is not limited to questions of remuneration policies and practices. In particular, the SMSG would like to highlight the specific conflict of interests which arise when financial institutions are selling their own shares or other financial instruments (preferred shares, hybrid securities and or debt) to their own clients (self-placements).
  - The Guidelines require that « When designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced ». What constitute an « appropriate balance » is left for financial firms to decide, subject to the list of bad practices included in the Guidelines. However, some members of the SMSG are of the view that the concept of “appropriate balance“ leaves too much room for flexibility and even that precise caps in percentage should be introduced in the Guidelines. However, the SMSG as a whole notes that a cap in absolute number would be difficult to enforce in certain circumstances.
  - The SMSG would like to highlight the risks associated with 100% variable remuneration structures. This type of remuneration is usually paid to tied agents or to outsourced entities. However, this type of remuneration creates a significantly higher risk of mis-selling. It should, therefore, be subject to enhanced scrutiny by regulators.
  - The SMSG supports ESMA’s guidance that non- financial (qualitative criteria), and not only quantitative criteria should be used in the determination of variable remuneration policies and practices and in the assessment of the performance of relevant persons. The SMSG recommends that the Guidelines state that such criteria should be a significant part of the assessment.
  - The SMSG would like to highlight the importance of enforcement in this area. Many of the poor practices cited in the Consultation have no place in a marketplace where firms must act in the best interests of clients. Where supervisors find evidence of poor practice in breach of MiFID, enforcement action should follow.
  - The SMSG supports the inclusion of a statement in the ESMA Guidelines to the effect that firms should address the potential conflict of interest of sales managers if they are allowed to play a significant role in the business quality monitoring of their own sales staff.
  - Finally, the SMSG supports the idea that proportionality has no place in the area of mis-selling. Although the concept of proportionality is not just related to size, but also needs to reflect the sector, the strategy, etc, the fact that a firm is small should not in itself be an excuse for poor remuneration and related selling practices.
-

## I. Explanatory remarks

1. On September 17, 2012 ESMA published a consultation paper relating to proposed Guidelines on remuneration policies and practices (ESMA/2012/570). The purpose of these Guidelines is to ensure the consistent and improved implementation of the existing MiFID conflicts of interest and conduct of business requirements in the area of remuneration.<sup>1</sup>
2. Remuneration, which is covered by the draft Guidelines, is to be distinguished from inducements. These Guidelines do not cover inducements under Article 26 of the MiFID Implementing Directive 2006/73/EC ("Level 2 Directive"). Inducements are paid by third-parties while remuneration is paid by the financial firm to its own staff and/or to related parties. However, both give rise to the same types of client protection issues.
3. Although these Guidelines principally address situations where services are provided to retail clients, they are also applicable, to the extent they are relevant, when services are provided to professional clients (MiFID Articles 13 and 18 apply irrespective of the retail or professional nature of the clients).
4. The Guidelines apply in relation to the provision of the investment services listed in Section A of Annex I of the Markets in Financial Instruments Directive (MiFID) and ancillary services listed in Section B thereof.
5. The Guidelines cover client-facing front-line staff, sales force staff, and/or, other staff indirectly involved in the provision of investment services whose remuneration, if not properly structured, may create inappropriate incentives to act against the best interests of their clients
6. The adoption of these Guidelines by ESMA is subject to article 16 of the ESMA Regulation which provides that ESMA "shall, with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervisors (ESFS), and to ensuring the common, uniform and consistent application of Union law, issue Guidelines and recommendations addressed to competent authorities or financial market participants". The Guidelines are addressed to competent authorities, which are subject to the "comply or explain" approach imposed by article 16(3) of the Regulation. Competent authorities are the authorities designated by a Member State under Article 48 of the MiFID to carry out the duties provided for under MiFID. The Guidelines are also addressed to certain financial market participants: investment firms (as defined in Article 4(1)(1) of MiFID), as well as credit institutions, UCITS management companies and external Alternative Investment Fund Managers (AIFMs) when providing investment services.<sup>2</sup> However, these financial participants are not under a duty to report, "in a clear and detailed way, whether they comply with that Guideline...".
7. The Guidelines constitute a new development at the EU level. They are based solely on the current MiFID requirements and they do not duplicate previous work by the Committee of European Securities Regulators (CESR). However, they build on existing experience developed by national regula-

---

<sup>1</sup> Articles 13(3), 18 and 19 of MiFID, and Articles 21, 22 and 23 of the MiFID Implementing Directive.

<sup>2</sup> These Guidelines only apply to UCITS management companies and AIFMs when they are providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD).

tors. Also, the European Commission's consultation paper on the MiFID review specifically mentions that "*Conflicts of interest requirements... includes the remuneration of sales forces and the structure of incentives for the distribution of financial products. (...) The key element of this framework is the management and the avoidance of conflicts – not just disclosure* ».<sup>3</sup> Therefore, ESMA will consider whether these Guidelines will need to be revised on MiFID 2 implementation.

### **III. General comments of the Group on Guidelines on remuneration policies and practices**

8. As mentioned, the Stakeholder Group supports the adoption of the Guidelines on remuneration policies and practices and the overall approach adopted by ESMA.
9. As a starting point, the Stakeholder Group agrees with the catch-all approach of the Guidelines as to what constitutes remuneration: « all forms of payments or benefits provided directly or indirectly by firms to relevant persons in the provision of investment and/or ancillary services to clients ».<sup>4</sup>
10. The SMSG also supports the view that « where entities or persons provide services to firms on the basis of an outsourcing arrangement or as tied agents, the remuneration provided by firms to the outsourced entity or person or tied agent is also regarded as remuneration for the purposes of these Guidelines ».<sup>5</sup> Outsourcing arrangement and tied agents create enhanced risks of mis-selling and should therefore be subject to the Guidelines. The SMSG also agrees with the Guidelines which state that « firms should also ensure that the tied agents and outsourced entities have remuneration policies and practices that are equally as effective as the firms' own arrangements in addressing and mitigating the potential conduct of business and conflict of interest risks ». The investment firm which is paying the outsourced entity of the tied agent should face responsibility, to a reasonable extent, in case of failure.
11. The Stakeholder group also supports the view that « non-monetary benefits (such as health insurance, discounts, or special allowances for car or mobile phone etc) » should be covered.<sup>6</sup> Those soft-money rewards, which can also include other forms (such as foreign travels) should be covered, especially when they are part of a variable remuneration. The Guidelines could provide some more examples of « non-monetary benefits ». However, the way to deal with non-monetary benefit should not be too bureaucratic and also target those benefits which are material.
12. Finally, the SMSG supports the idea that the issue of proportionality has no place with regard to mis-selling. Although the concept of proportionality is not just related to size, but also needs to reflect the sector, the strategy, the fact that a firm is small should not be an excuse for poor remuneration and related selling practices. This is all the more the case given that, as noted by ESMA, the changes and costs associated with these Guidelines should mainly fall on firms that are currently non-compliant with existing MiFID regulatory requirements.

---

<sup>3</sup> "Review of the Markets in Financial Instruments Directive (MiFID)", European Commission, 8 December 2010, page 70.

<sup>4</sup> Point 10, p. 6.

<sup>5</sup> Point 10, p. 6.

<sup>6</sup> Point 11, p. 7.

## **V.I. Governance and design of remuneration policies and practices in the context of the MiFID conduct of business and conflicts of interest requirements**

*Q1 Do you agree that firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties and conduct of business risk management obligations so as not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests, to the potential detriment of clients? Please also state the reasons for your answer.*

13. The SMSG agrees with the view that firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties and conduct of business risk management obligations. The Stakeholder Group also agrees that priority should be given to avoiding conflict of interest rather than to simply managing or disclosing them. This is all the more the case as disclosure of conflicts of interest has repeatedly been shown not to provide retail investors with effective protection against mis-selling risks.
14. However, the SMSG would like to stress that the remuneration of staff represents only one channel through which mis-selling risk can arise. Inducements and poor suitability assessment can also generate mis-selling risks. In particular, the SMSG would like to highlight the enhanced risks which arise with respect to self-placement by firms of their proprietary financial instruments (shares, preferred shares, hybrid securities and/or debt). Strong conflict of interest risk arises in this context even if there is no specific remuneration attached to the selling of the instruments.
15. Self-placement is not wrong per se. However, already the situation of a self-placement creates a strong conflict of interest. Close monitoring of these sales is necessary. In certain circumstances, however, particularly where financial stability risks arise, there may be political and other circumstance which mean that national action may not be as effective as it should be. Therefore, ESMA should consider whether specific provisions should be developed in this area.

*Q3 Do you agree that when designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced?*

*And*

*Q4 Do you agree that the ratio between the fixed and variable components of remuneration should therefore be appropriate in order to take into account the interests of the clients of the firm? Please also state the reasons for your answer.*

16. The Guidelines mention that « When designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced. Furthermore, the remuneration mechanisms in place should allow the operation of a flexible policy on variable remuneration, including, where appropriate, the possibility to pay no variable remuneration at all ».<sup>7</sup> They also mention that « High variable remuneration can increase the relevant person's focus on short-term gains rather than the client's best interest. The ratio between the fixed and variable components of the remuneration received should therefore be appropriate in order to take into account the interests of all stakeholders (including firms' clients) ».<sup>8</sup>

---

<sup>7</sup> Point 16 of the Guidelines and 45 of the Consultation

<sup>8</sup> Point 17 of the Guidelines and 46 of the Consultation

17. The SMSG agrees with the overall approach of the Guidelines and that when designing remuneration policies and practices, firms should ensure that the fixed and variable components of the total remuneration are “appropriately balanced”. Although risky, the SMSG does not think that 100% variable remuneration should be prohibited per se but that 100% variable remuneration should be subject to carefully risk assessment by firm’s senior management and to close monitoring by the supervisor.
18. It is particularly difficult to ascertain what constitutes “appropriately balanced” remuneration in the case of “tied agents” and of outsourced entities. The Guidelines do not prohibit 100% variable remuneration for these financial intermediaries. However, ESMA might want to focus more specifically on tied agents at a later stage, even if the treatment of inducements in the MiFID review/MiFID II negotiations might help to alleviate concerns. The SMSG also is aware of the fact that relationships between financial firms and tied agents are based on numerous contractual arrangements and that changing their compensation structure would demand significant effort and time of firms. This should be taken into consideration when and if ESMA decides to provide more specific guidance at a later stage.
19. Apart from the specific issue of tied agents, a minority of members of the SMSG think that ESMA should move towards a more restrictive approach. According to this approach, ESMA could include in the Guidelines a specific cap in percentage for variable remuneration. However, the SMSG as a whole notes that a cap in absolute number would be difficult to enforce in certain circumstances. For instance, Placement Agents are typically used by MiFID regulated Private Equity Advisors/Sponsors. These financial intermediaries are typically remunerated by way of an up-front negotiated success fee agreement where the fee is set as a certain % of the "fund commitments" secured/committed by the professional investor to whom the placement agent has acted as "middleman". Not knowing beforehand how much the investor would commit would make it difficult to cap the fee in absolute numbers.

*Q5 Do you agree that the performance of relevant persons should take account of non-financial (such as compliance with regulation and internal rules, market conduct standards, fair treatment of clients etc.), as well as financial, criteria? Please also state the reasons for your answer.*

20. The SMSG supports the use of non-financial (qualitative) criteria in the assessment of the performance of relevant persons. Although it is more difficult to assess performance of relevant persons through non-financial criteria, they should certainly be part of the criteria taken into account for remuneration. The SMSG recommends that the Guidelines state that such criteria should be a significant part of the assessment. This would also reflect the more general move in the wake of the financial crisis to remove incentives for excessive risk taking and to support good practices through remuneration-related incentives. The quality of the advice given should be an important element of remuneration structures. Although some could argue that mere compliance with regulatory requirements and internal procedures, market conduct standards, fair treatment of clients and business retention should be a given, it is fair to reward adequately relevant persons who abide by these rules and to provide incentives for good practice.
21. The Guidelines provide some examples of non-financial criteria. For instance, the Guidelines provide as example of good practice « rates of business retention (or lapses); ....complaints about advice etc. » and mentions a situation where « References used in the calculation of variable remuneration

of staff are common across products sold and include qualitative criteria ».9 These examples could be expanded and be even more specific. In this regard, the FSA Guidance Consultation of September 2012 on « Risks to customers from financial incentives » provides some useful examples. For instance, the ESMA Guidelines could provide that in the case of poor behavior or mis-selling, the relevant person could be removed from the incentive scheme or suffer a reduction in bonus payments depending on the how serious and frequent the problem is.

*Q6 Do you agree that the design of remuneration policies and practices should be approved by senior management or, where appropriate, the supervisory function after taking advice from the compliance function? Please also state the reasons for your answer.*

*and*

*Q7 Do you agree that senior management should be responsible for the implementation of remuneration policies and practices, and for preventing and dealing with any the risks that remuneration policies and practices can create? Please also state the reasons for your answer.*

22. The Stakeholder Group fully supports this approach since it is normal and appropriate that senior management assume responsibility for the design of remuneration policies and practices, given the potential for poor incentives and investor detriment. As a consequence, they should also face potential administrative sanctions in case of failure or lack of appropriate supervision. The Group also supports the close involvement of the compliance function in the design of remuneration policies and practices.

23. Senior management might have a conflict of interest in designing the remuneration policies and practices. Therefore, the SMSG would like to highlight the need for national regulators to be closely involved in the monitoring of such remunerations and policies.

*Q8 Do you agree that the organisational measures adopted for the launch of new products or services should take into account the remuneration policies and practices and the risks that the new products or services may pose? Please also state the reasons for your answer.*

24. The Group agrees that product/service design processes should take into account related remuneration risks. It also supports this focus on new product/service governance given the current trend across the EU, and at EU level, to address the product development process, including through the ongoing MiFID II negotiations. The product design process represents an important ‘upstream’ opportunity to address the potential for mis-selling risks.

25. In particular, the Stakeholder Group supports the highlighting in the Guidelines of examples of good and bad practices.<sup>10</sup> It also agrees with the view stated in the explanatory part of the Guidelines<sup>11</sup> and in the « Impact Assessment » accompanying the proposed recast of the MiFID Directive (20 October 2010) that “Where firms’ remuneration policies and practices link remuneration directly to the sale of specific financial instruments or of a specific category of financial instrument, it is unlikely that such firms could, in this situation, demonstrate compliance with MiFID ». It should be forbidden to link remuneration directly to the sale of specific financial instruments, since it cannot

---

<sup>9</sup> Point 25, page 36.

<sup>10</sup> Point 54 and 55, p. 16.

<sup>11</sup> Point 56, p. 16.

be in line with appropriate advice which reflects the best interests of the client. In view of the importance of this statement, ESMA should consider including it in the Guidelines themselves and not just in the explanatory text of the Consultation paper.

*Q9 Do you agree that the process for assessing whether the remuneration features related to the distribution of new products or services comply with the firm's remuneration policies and practices should be appropriately documented by firms? Please also state the reasons for your answer.*

26. The SMSG agrees that the process for assessing whether the remuneration features related to the distribution of new products or services comply with the firm's remuneration policies and practices should be appropriately documented by firms. This ensures appropriate focus on remuneration design and also supports the supervisory and enforcement process.

## **V.II. Controlling risks that remuneration policies and practices create**

*Q10 Do you agree that firms should make use of management information to identify where potential conduct of business and conflict of interest risks might be occurring as a result of specific features in the remuneration policies and practices, and take corrective action as appropriate? Please also state the reasons for your answer.*

27. The SMSG supports the view, which is reinforced by supervisory experience, that senior management or, where appropriate, the supervisory function should be appropriately informed about any relevant issues regarding these topics. All efforts should be made to prevent conflict of interest.
28. The SMSG agrees that properly resourced Management Information (MI) tools and databases are an important resource for assessing where potential risks can arise with respect to remuneration. The development and use of Management Information resources should also ensure an appropriate level of focus by senior management on remuneration risks and allow firms to demonstrate compliance with the obligation to act in the best interests of the client. Such systems also provide a useful mechanism for supervisory oversight of remuneration systems and of compliance with 'best interest' obligations. Overall responsibility for the design and resourcing of these tools should rest with senior management.
29. The SMSG is of the view that it would be helpful were ESMA to provide additional examples on the type of data which a well-designed Management Information system should capture.

*Q11 Do you agree that firms should set up controls on the implementation of their remuneration policies and practices to ensure compliance with the MiFID conflicts of interest and conduct of business requirements, and that these controls should include assessing the quality of the service provided to the client? Please also state the reasons for your answer.*

30. The Stakeholder Group supports the requirement in the Guidelines that "firms should set up adequate controls for compliance with the MiFID conflicts of interest and conduct of business requirements ». It also fully supports the view that « Such controls should include assessing the quality of the service provided to the client, for example monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability or going through other client documentation on a regular basis ».



31. The Group suggests additionally that firms should collate feedback from clients as part of their efforts to control conflicts of interests and assess the quality of the service provided.

*Q12 Do you agree that the compliance function should be involved in the design process of remuneration policies and practices before they are applied to relevant staff? Please also state the reasons for your answer.*

32. The SMSG agrees with the statement that « The compliance function should be involved in the design process of remuneration practices before they are applied to relevant staff ». Involvement of the compliance function after remuneration policies and practices have been elaborated would be too late to influence them. The Stakeholder Group also supports the statement that « Persons engaged in control functions should be independent from the business units they oversee, have appropriate authority, and should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control ». The compliance officer is potentially the only person with an independent view on these conflicts of interest.
33. This raises the question of whether supervising staff should be allowed to earn incentive payments based on the volume of sales made by those staff when they play a significant role in the business quality monitoring of their own sales staff ? The FSA Guidance Consultation of September 2012 on « Risks to customers from financial incentives » states that « Sales managers can have conflicts of interest where they are responsible for supervising staff and also earn incentive payments based on the volume of sales made by those staff, especially if they play a significant role in the business quality monitoring of their own sales staff. Firms should reduce or manage these conflicts of interest ».<sup>12</sup> Therefore, the SMSG supports the inclusion of a statement in the ESMA Guidelines to the effect that firms should address the potential conflict of interest of sales managers if they are allowed to play a significant role in the business quality monitoring of their own sales staff.

### **V.III. Annex I: Illustrative examples of remuneration policies and practices that create conflicts that may be difficult to manage**

*Q13 Do you agree that it is difficult for a firm, in the situations illustrated above in Annex I, to demonstrate compliance with the relevant MiFID rules?*

*And*

*Q14 If you think some of these features may be compatible with MiFID rules, please describe for each of (a), (b), (c) and (d) in Annex I above which specific requirements (i.e. stronger controls, etc) they should be subject to.*

34. The Stakeholder Group supports the focus of the Annex I of the Guidelines on « *Examples of high risk remuneration policies and practices* ». The SMSG agrees that it is difficult for a firm, in the situations illustrated in Annex I, to demonstrate compliance with the relevant MiFID rules.
35. The Group is also of the view that the examples, in many cases, represent very poor practice and carry very high mis-selling risks. Practices such as these should receive close supervisory attention and be subject to enforcement action where breaches of MiFID are clear. While Guidance is a useful

---

<sup>12</sup> FSA, Guidance Consultation, Risks to customers from financial incentives, September 2012, p. 23.

tool, enforcement brings with it useful deterrent effects for the market, as well as for the individual firms concerned.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 23 November 2012

A handwritten signature in black ink, appearing to read 'G Prache', with a long horizontal stroke extending to the right.

Guillaume Prache

Chair  
Securities and Markets Stakeholder Group