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Our reference

Encl.
Updated notification of additional requirements under Article 4 of Directive 2006/73/EC

Date 27 MEI 2016
Subject Notification of an exemption to the additional requirements under Article 4 of Directive 2006/73/EC

Dear Mr Lueder,

I am writing in accordance with Article 4 paragraph 3 of Directive 2006/73/EC to notify you of an exemption on the additional requirements regarding inducements the Netherlands is imposing per 1 April 2016 in accordance with Article 4 paragraph 1 of Directive 2006/73/EC. Please find enclosed an updated version of the original notification regarding the aforementioned exemption on these requirements.[1]

Yours sincerely,

Director of Financial Markets,

G.J. Salden

[1] Reference original notification: FM 2013-2120 M.

Notification of additional requirements under Article 4 of Directive 2006/73/EC

This notification relates to the introduction of a ban on the receipt or provision by investment firms of fees, commissions or any monetary or non-monetary benefits provided by or to third parties ("inducements") in the Netherlands per 1 January 2014. With these additional requirements the Netherlands aims to tackle the risks to investor protection arising from third party inducements that are not adequately addressed by Directive 2004/39/EC ("MiFID") and Directive 2006/73/EC ("Level 2 Directive"). This notification sets out how the additional requirements are in accordance with Article 4 of the Level 2 Directive and is structured as follows:

1) description of the additional requirements;
2) description of the specific risks to investor protection not adequately addressed by Directive 2006/73/EC;
3) explanation of how these risks are of particular importance in the circumstances of the market structure in The Netherlands;
4) explanation of why the additional requirements are proportionate;
5) description of how the additional requirements would affect the rights of investment firms under Article 32 and 32 of Directive 2004/39/EC.
6) [UPDATE 2016] description of the exemption on the additional requirements aimed at crowdfunding, to be introduced in April 2016.

1) Description of the additional requirements

Our current approach to addressing the risks arising from inducements derives directly from the approach set out in Article 26 of the Level 2 Directive and relies significantly on the disclosure of any payments and non-monetary benefits provided by or to third parties. Unfortunately, this approach has not proven as effective as we hoped in adequately addressing the risks arising from inducements and ensuring that investments firms act in accordance with their obligation under Article 19 of MiFID.

With the Amendment Decree Financial Markets 2014 (*Wijzigingsbesluit financiële markten 2014*), which will enter into force per 1 January 2014, the Netherlands seeks to address the risks arising from inducements more simply and directly. As of 1 January, investment firms are not permitted to receive or provide fees, commissions or any monetary or non-monetary benefits provided by or to third parties in relation to the provision of investment services or ancillary services to retail clients. Our amended approach is centered on the principle that an investment firm should be remunerated by its clients only. Exclusive remuneration by the client will ensure that investment firms focus on and act in the best interests of their clients, rather than the inducements provided by third parties.

The ban on inducements will apply to the provision of portfolio management, investment advice and execution only services to retail clients. Consequently, inducements received from or provided to third parties for the provision of investment services to professional clients and eligible counterparties will still be permitted, on the condition that these payments meet the criteria as set out in

Article 26 of the Level 2 Directive. The same applies to the provision of the investment services underwriting of financial instruments and/or placing of financial instruments on (or without) a firm commitment basis (Annex I, Section A under 6 and 7 of MiFID). Furthermore, the ban on inducements will not be applicable to:

- proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees;
- payments between an investment firm and its (registered) tied agent ; and
- promotional gifts that do not exceed a value of € 100.

The ban on (third party) inducements in the Netherlands is designed to create a more direct and effective approach to the risks arising from inducements and can as such be considered an additional requirement under Article 4 of the Level 2 Directive. Nonetheless, while drafting the additional requirements we have closely taken into account the framework that is already in place in MiFID and the Level 2 Directive and we believe that the requirements are consistent with, and reinforce, the approach outlined in Article 19 paragraph 1 MiFID and Article 26 of the Level 2 Directive.

2) *Description of the specific risks to investor protection not adequately addressed by Directive 2006/73/EC*

As mentioned above, our current approach to addressing the risks arising from inducements derives directly from the approach set out in Article 26 of the Level 2 Directive. According to these requirements fees, commissions and other monetary or non-monetary benefits paid to or received from third parties are only permitted when they are disclosed in advance to the client, they are designed to enhance the quality of service to the client and, they do not impair the duty of the investment firm to act in the best interests of the client.

Overall, this approach has not proven effective in adequately addressing the risks arising from inducements and ensuring that investments firms act in the best interests of the client. In spite of disclosure requirements, retail clients commonly lack an understanding of how and if inducements can influence the service provided to the client. In practice, clients are unable to comprehend and make use of the information designed to assist them in challenging their investment firms about the payments made to them. As a result, retail clients are unable to effectively counterbalance investments firms on this issue, which consequently means that the risks arising from inducements remain unaddressed.

Under the current rules of Article 26 of the Level 2 Directive, inducements continue to provide investment firms with incentives not to act in the best interest of the client. It is still common market practice that product providers and executing brokers pay fees, commissions or other monetary and non-monetary benefits to investment firms. CESR has described such payments in its report "Inducements: Report on good and poor practices" and has signaled several practices where inducements can give rise to significant conflicts of interest.[2] This is most evident for payments by product providers to investment firms as compensation for using the distribution channel of the investment firm to market a product and payments linked to brokerage and settlement volumes, such as kick-back payments between investment firms related to order execution venues.

These inducements continue to provide investment firms with incentives to advise clients to buy – or in the case of portfolio management to buy on behalf of the client – investment products that offer the highest commission or rebate instead of selecting the investment product that is in the best interest of the client. In general, inducements may provide investment firms with an incentive to pre-select the products it offers (regardless of the type of service provided) based on the amount of rebate it offers to investment firms. This may also cause the investment firm to promote these products more vigorously. Investment products that pay high rebates are often not in the best interest of the client, since high rebates lead to high product costs and affect product performance. Additionally, inducements may limit the range of cost-efficient products offered by investment firms (e.g. ETF's) as these products offer lower or no commissions or rebates. Payments linked to brokerage and settlement volumes can provide an incentive for investment firms to increase the number of transactions to generate a higher income, which is also not automatically in the best interest of the client.

The European Commission has recognized that the current requirements under Article 26 of the Level 2 Directive have not always proven to be very clear or well articulated for investors and that their application has created practical difficulties and concerns. Further, the Commission has acknowledged that, although the firm should always act in the best interests of the client, the possibility to accept inducements when providing advice and portfolio management can decisively compromise this principle and lead to sub-optimal choices on behalf of the investor.[3] Indeed, in practice it can be difficult to establish whether bias has arisen in the services provided to the client and whether inducements have compromised the principle that an investment firm should always act in the best interests of the client. Given this, we believe a ban on inducements is necessary to effectively address the risks arising from inducements and to ensure that investment firms act in accordance with their obligation under Article 19 of MiFID.

3) *In what way are the risks of particular importance in the circumstances of the market structure in The Netherlands?*

The decision to introduce a ban on inducements for investment firms reflects several important features of the market structure in the Netherlands. Most importantly, investment firms in the Netherlands are relatively dependent on the payment of inducements by third parties like product providers. On average, investment firms gain a substantial part of their income through inducements;

[2] CESR, 'Inducements: Report on good and poor practices', 19 April 2010, CESR/10-295.
[3] Commission Staff Working Paper Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council on Markets in financial instruments [Recast] and the Proposal for a Regulation of the European Parliament and of the Council on Markets in financial instruments, , 20 October 2011, p. 16-17.

some investment firms are almost completely dependent on inducements for their income. Within this context, the potential impact of third party inducements on the services provided to clients is large. This emphasizes the necessity to eliminate the incentives that inducements can provide to investment firms.

Under the current requirements for inducements, we have relied upon client awareness of the inducements being paid to their investment firms to mitigate the risk of inducements affecting the services provided to clients. However, as previously explained, retail clients generally struggle to understand how their investment firm is paid and how inducements may have an impact on the service provided and on the value of their investment. Consequently, in order to ensure that inducements do not impair compliance with the obligation for an investment firm to act in the best interests of the client, it is necessary to further restrict the receipt or provision by investment firms of inducements.

Although our amended approach towards inducements is designed to reduce and ideally eliminate the risks arising from inducements (e.g. product provider bias), the decision to introduce a ban on inducement also takes into account other circumstances that are of concern in the market structure of the Netherlands. The market for investment services in the Netherlands is to a large extent concentrated at a few large banks. Nonetheless, there are more than 250 investment firms active on the Dutch market, with substantial amounts of clients. With the introduction of a ban on third party inducements, investment firms will only be permitted to receive payment from their clients, thus enabling retail investors to better compare investment products and investment services. This will stimulate (smaller) investment firms to demonstrate the added value of the services they provide and enhance competition between investment firms.

Furthermore, the introduction of a ban on third party inducements for investment firms is necessary to create a level playing with non-MiFID financial services providers. As of 1 January 2013, advisors and intermediaries are already subject to a ban on third party inducements for the provision of services with regard to complex financial products, mortgage credit and some insurance products (e.g. life assurance). This illustrates that our concerns about the potential for inducements to bias advice or other services are by no means confined to investment services. Miss-selling cases have occurred in the Netherlands on a large scale and have not been confined to one sector, but involved for example life insurance products, equities and mortgage endowments. This has led to public mistrust toward the financial sector. With the introduction of a ban on third party inducements for investment firms, indirect remuneration (meaning not by the client) will be prohibited market wide, thus providing a level playing field between investment firms and other (non-MiFID) financial services providers. This is important given the fact that both provide services in relation to different types of investment products (such as life insurance bonds versus collective investment funds), highlighting the risks of remuneration bias that relates to a certain type of product or service. Additionally, we believe that drastically reforming the way investment firms and other financial institutions are remunerated for their services, contributes to the culture change that is necessary to restore public trust in the financial sector.

4) Explanation of why the additional requirements are proportionate

Our proposal to ban third party inducements for investment firms aims at effectively addressing the risks arising from third party inducements in a proportionate way, while at the same time respecting the framework that is already in place on a European level. This approach is best illustrated by the decision to limit the ban on inducements to retail clients. We recognize that professional clients and eligible counterparties dispose of sufficient knowledge (or the ability to take on that knowledge) and volume of transactions to effectively counterbalance investment firms on inducements. Additionally, the nature and costs of services provided to these categories of clients are not standardized, but the result of negotiations between the investment firm and the client. Given this, we have not extended the proposed requirements to professional clients and eligible counterparties. We believe the existing rules of Article 26 of the Level 2 Directive are sufficient and more appropriate.

Another example of why our approach to inducements is proportional is provided by the fact that we do not propose any other additional requirements than a direct ban on third party inducements. Our proposal leaves investment firms with the choice as to how they structure their charges to the client. Additionally product providers will also retain the freedom to offer different prizes for their products, allowing competition to operate effectively. By maintaining this freedom, we are confident of creating a proportionate approach to address the risks arising from third party inducements.

With regard to the scope of the ban on inducements (the ban applies to portfolio management, investment advice and execution-only), we would like to remark that we acknowledge that the risks arising from inducements are different and more limited for execution-only services. As we previously noted, inducements may provide investment firms with an incentive to pre-select the products it offers based on the amount of rebate it offers to investment firms; this also affects execution-only services. In addition, we feel our approach is necessary and proportionate because applying different inducement rules to investment advice, portfolio management execution-only may provide investment firms with an incentive to push investors to the type of service that still allows inducements, instead of encouraging clients to choose the service which is in the best interest of the client (the so-called 'waterbed' effect). Differentiation in the application of inducement rules on the various investment services may also encourage investors to choose the service that still allows inducements, since these services may seem less costly to them as inducements are not visible or less visible to the client.

Finally, it is worth noting that the viability of the approach proposed in this notification is already demonstrated by some investment firm. During the past several years, firms (mostly independent portfolio managers) have shown a grown interest in business models where remuneration is exclusively provided by the client. Some of these firms have already implemented this business model. In general, the industry in the Netherlands is supportive of the ban on third party inducements and therefore we are confident that this is a proportionate and viable approach for the future.

5) *Description of how the additional requirements would affect the rights of investment firms under Article 32 and 32 of Directive 2004/39/EC*

The additional requirements described in this notification will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of MiFID. The requirements will not apply to firms exercising rights under Article 31, but will only apply to firms exercising rights under Article 32 in the circumstances as set out in Article 32 paragraph 7 MiFID.

6) *Description of the exemption on the aforementioned additional requirements aimed at crowdfunding*

The ban on inducements for investment firms has been identified as a possible hurdle for the development of investment-based crowdfunding in the Netherlands. In the case of investment-based crowdfunding, funds are provided in the form of debt or equity securities. This means that a crowdfunding platform acting as an intermediary for these types of projects generally provides investment services and therefore qualifies as an investment firm under MiFID. According to the ESMA Opinion on Investment-based crowdfunding published on 18 December 2014 (ESMA/2014/1378), the typical investment service provided by crowdfunding platforms in the investment-based sector is 'reception and transmission of orders'. The crowdfunding platform is thought to receive orders from investors (the 'crowd') and transmitting them to the project owner, who in turn issues securities.

Normally, regardless of the specific type of crowdfunding, a platform charges both the project owner as well as investors for the services it provides. However, with regard to the ban on inducements, the project owner qualifies as a 'third party'. Within the ban on inducements an investment firm is not allowed to receive fees from third parties; a crowdfunding platform is therefore not allowed to charge the project owner. This leads to an unlevel playing field between investment-based crowdfunding and other types of crowdfunding (particularly loan-based), as platforms acting as intermediaries in for example loan-based crowdfunding are allowed to charge both project owners and investors for the services they provide. A loan-based platform will therefore be cheaper for investors. This may lead to a crowding out effect, where project owners and investors more often choose loan-based crowdfunding, even in cases where funding through securities would be better suited. In other words: not only the wishes and needs of market participants influence the type of available forms of crowdfunding, but also the relevant regulatory scheme. The ban on inducements may therefore be an obstacle to the development of investment-based crowdfunding in the Netherlands. This is illustrated by the fact that of the forty-eight crowdfunding platforms currently registered with the Dutch Financial Markets Authority, only four provide investment services. With a targeted exemption on the ban on inducement for crowdfunding, the Netherlands is hoping to remove this obstacle and provide a better level playing field for different types of crowdfunding. The exemption on the ban on inducements for crowdfunding is part of the Amending Decree Financial Markets 2016, that enters into force on April 1st 2016.

As this notification letter puts forward, the Netherlands believes a ban on inducements is necessary to effectively address the risks arising from inducements and to ensure that investment firms act in accordance with their obligation under Article 19 of MiFID to act honestly, fairly and professionally in accordance with the best interests of its clients. Inducements may provide an investment firm with the incentive to guide investors to products for which the investment firm will receive the highest fee from the party offering the product, or to only carry products for which the investment firm will receive a relatively high fee. The exemption on the ban on inducements for crowdfunding may therefore introduce incentives for crowdfunding platforms to not act in the best interest of its clients. These incentives are however mitigated by the specific characteristics of crowdfunding. Generally speaking, crowdfunding platforms do not provide investment advice. Platforms are therefore not able to directly lead consumers to certain projects. Moreover, in order to profit from the exemption, a crowdfunding platform is not allowed to provide investment advice.
Regarding the incentive to only carry certain products, a platform also has an incentive to advertise a broad range of projects in order to cater to the interests of as many investors as possible. This will subsequently lead to as many successful projects as possible and revenue for the platform. By limiting the number of projects, certain investors may not be reached. As a result, this phenomenon will mitigate the incentive for the crowdfunding platform to only select certain, high yield projects. Furthermore, the general MiFID-rules regarding inducements will remain in effect under the exemption. An inducement must be designed to enhance the quality of the relevant service to the client, may not impair compliance with the platform's duty to act in the best interest of the client and must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment service.

The overarching goal of the ban on inducements is furthermore safeguarded by a number of conditions, designed to limit improper use of the exemption. The use of the exemption is limited to platforms that provide the investment service 'reception and transmission of orders in relation to one or more financial instruments' in relation to the initial offering of equity or debt instruments by parties wanting to finance a specific project. As an additional requirement platforms are not allowed to provide the investment services 'execution of orders on behalf of clients', 'portfolio management' and 'investment advice'. If a platform provides (a combination of) these investment services, it more closely resembles a traditional investment firm with corresponding incentive structures. In the light of the goal of the ban on inducements, an exemption on the ban on inducements is not justified in such a case.

Finally, the exemption on the ban on inducements ought to be seen within the context of a rapidly developing market. The Dutch Financial Markets Authority monitors the growth and further professionalization of crowdfunding closely. It also biannually evaluates newly taken measures with regard to crowdfunding, including the exemption on the ban on inducements. If the services provided by crowdfunding platforms develop in such a way that the exemption is no longer justified due to concerns on consumer protection, the exemption will be reconsidered.