

Retail distribution review in the Netherlands: a gradual introduction of a ban on third party inducement fees

Financial services providers operating in the Netherlands including but not limited to investment firms licensed in accordance with the Markets in Financial Instruments Directive (2004/39/EC, the "MiFID"), should take note of recent developments concerning the regulation of inducements, ie fees, commissions or promotional gifts. The inducement rules are intended to prevent inducements being paid or provided to financial advisors and intermediaries at the detriment of the interest of the client.

A distinction can be made between inducement rules applicable to:

- banks and investment firms which are subject to the MiFID
- non-MiFID financial services providers.

Below, we will elaborate on the current rules and the proposed rules for both MiFID firms and financial services providers.

The rules applicable to financial services providers particularly affect advisors and intermediaries in financial products such as mortgage credit, income insurances, unit-linked insurances, annuities and non-life insurances. The proposals to amend the rules for financial services providers follow a previous amendment of the inducement rules, which introduced a MiFID like inducement regime for financial services providers from 1 January 2009.

Key issues

- Potential ban on all third party inducement fees received by financial services providers
- Non-life insurance advisors and intermediaries subject to inducement rules per 1 January 2012
- Proposed separation of advice and product charges per 1 January 2013

In addition to providing an overview of current requirements, this briefing discusses proposed further restrictions on third party inducement fees (eg fees paid by product providers) and a potential ban on all third party inducements. It also discusses proposed legislation for non-MiFID financial services providers and product providers to be more transparent with regard to fees and commissions.

1. MiFID-firms

1.1 Scope of current rules

The Dutch inducement rules which are the subject of this briefing stem from the MiFID, in particular from article 26 of the MiFID implementing Directive (2006/73/EC), and are to a large extent identical to the MiFID rules. The MiFID regulates investment firms. An investment firm means any legal person whose business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.

Investment services comprise services relating to financial instruments (which include securities, units in mutual funds, options, swaps, forward rate agreements, contracts for differences and any other derivative contracts relating to securities, commodities, currencies, interest rates or yields) such as:

- reception and transmission of orders
- execution of orders on behalf of clients
- portfolio management
- investment advice; and
- underwriting and placing of financial instruments.

Investment activities also relate to financial instruments and include dealing on own account and (operating a multilateral trading facility (MTF).

The MiFID regulates not only investment firms licensed under MiFID, but also banks (licensed pursuant to the EU Banking Directive 2006/48/EC) that provide investment services or perform investment activities. Likewise, the Dutch inducement rules have been implemented in the Dutch Financial Supervision Act (*Wet op het financieel toezicht*, the "FSA") and apply to banks and investment firms (i) with a Dutch license; or (ii) from the US, Australia and Switzerland that have exempt status and are registered with the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*, the "AFM"). The inducement rules apply regardless of the type of client, ie the rules apply whether the client is a retail client or a professional investor. The rules do, in accordance with MiFID, not apply to EU banks and investment firms that have passported their MiFID license into the Netherlands; they are subject to their home state MiFID inducement rules.

1.2 Content of current rules

The current rules require that investment firms must not pay or be

paid, in relation to the provision of an investment service or ancillary service (as defined in the FSA) to the client, any fee or commission (or any non monetary benefit, hereafter together referred to as "commissions") which does not enable or is not necessary (see below) for the provision of investment services, other than the following:

- A commission paid to or by the client.
- A commission paid to or by a third party, where the following conditions are satisfied:
 - the client is informed in a detailed, accurate and understandable manner of the existence, nature and amount of the commission or, where the amount cannot be ascertained, of the manner in which it is calculated, before the service concerned is provided (a summary of the essential conditions of the commission arrangements may be provided if the client is informed of the possibility to obtain further details, which should subsequently be supplied on the client's request) and
 - the payment of the commission benefits the quality of the service concerned and does not

detract from the investment firm's obligation to promote the client's interests.

Commissions that enable or are necessary for the provision of investment services could include custody costs, settlement and exchange fees, regulatory levies or legal fees.

1.3 Proposals for amendments

Currently, there are no concrete Dutch proposals to change the MiFID based inducement rules. This is however likely to happen when MiFID II is implemented. In its consultation on the review of MiFID dated 8 December 2010 (the MiFID II review), the European Commission requested market participants' input on the Commission's proposals to amend the inducement rules. The Commission's questions and the input provided by the Dutch Government are described below. They relate to three issues; the current possibility to only provide a summary disclosure concerning inducements, a potential requirement for additional *ex-post* disclosure of inducements and a potential ban on third party inducements.

- **European Commission:** "What is your opinion of the removal of the possibility to provide a summary disclosure concerning inducements?"
Dutch Government: "We agree with this proposal. The starting point should always be a detailed disclosure. Such a disclosure is in the best interest of the client. Only when a detailed disclosure is not possible - for example because the exact amount is not known yet - other methods should be possible. We agree

that in such a situation the method of calculation should be disclosed *ex-ante* in combination with an *ex-post* disclosure of the exact amount."

- **European Commission:** "Do you consider that additional *ex-post* disclosure of inducements could be required when *ex-ante* disclosure has been limited to information methods of calculating inducements?"
Dutch Government: "Yes, an *ex-post* disclosure is still desirable to give the client insight in the inducements of the service. For example this could be a reason for a client to ask for further clarification."
- **European Commission:** "What is your opinion about banning inducements in the case of portfolio management and in the case of advice provided on an independent basis due to the specific nature of these services? Alternatively, what is your opinion about banning them in the case of all investment services?"
Dutch Government: "We are in favour of banning inducements in the case of portfolio management and in the case of advice provided on an independent basis and even extending the ban to other investment services. The reason is that an investment firm is obliged to act in the best interest of the client. In our opinion this result can only be reached in a situation where an investment firm is paid for its services only by the client. Only in such a situation can the investment firm act truly independently from a product provider or any other third party. We are in favour of extending such a ban to all investment

services. Only in such a situation will a level playing field be reached with investment firms that render services like advice, execution only and/or with companies that are exempted pursuant to article 3 MiFID. Further we have observed that few firms have been able to demonstrate appropriately that making or receiving inducements when providing investment services is designed to enhance the quality of the service provided to the client and does not impair compliance with the firm's duty to act in the best interests of the client."

As follows from the above, the Dutch Government is a clear proponent of banning all third party inducements, not only in relation to the provision of investment advice and individual asset management, but also in relation to other investment services. The Dutch Government, however, announced that it would wait for the MiFID II proposals and indicated that it could not alter the MiFID based inducement rules before those proposals were definitive (since MiFID operates on the basis of maximum harmonisation). The MiFID II proposals have in the meantime been published on 20 October 2011. They currently only include a ban on third party inducements with regard to portfolio management and investment advice. On the same day as the publication of the MiFID II proposals, the Dutch Minister of Finance informed the Dutch Parliament that during the further MiFID II negotiations he would dedicate himself to a full ban on third party inducements. He added that in the event that the final MiFID II would not include such a complete ban, he

intends to prohibit such inducements on the national level.

2. Financial services providers (non-MiFID products)

2.1 Scope of current rules

The MiFID inducement rules were a source of inspiration for the Dutch legislator when drafting the inducement rules for financial services providers (non-MiFID firms). While the first inducement rules for financial services providers became effective in January 2009 and have been amended slightly per 1 January 2012, the Dutch legislator is now considering a complete ban on third party inducements paid to advisors and intermediaries in certain financial (non-MiFID) products.

The inducement rules for non-MiFID financial services providers do not apply to all such regulated entities. Generally, the definition of financial services providers includes all product providers, intermediaries and advisors in respect of financial products that are not MiFID financial instruments (see par. 1.1 above), including:

- investment objects (eg participations in teak plantations, ostrich eggs or timesharing of property)
- current accounts including the ancillary payment facilities
- electronic money
- consumer credit
- savings accounts including the ancillary savings facilities
- insurances not being a reinsurance

- premium pension claims.

Generally, financial services providers are subject to a license requirement when operating in the Netherlands. In principle and except for banks and insurance companies, the license requirement is triggered only if services are provided to retail clients. Advisory and intermediary activities in respect of insurance are the exception to the rule, such activities are regulated regardless of the type of client.

The inducement rules for non-MiFID financial services providers currently do not apply to all of such services providers but only to advisors and intermediaries in:

- complex financial products (excluding MiFID products), eg unit-linked insurances and annuities
- mortgage credit
- payment insurance (insuring a borrower against the risks that he cannot pay back a credit)
- funeral insurance products; and
- non-life insurance advisors and brokers (from 1 January 2012).

Furthermore, from 1 January 2012, another category of financial services providers is subject to inducement rules. This concerns authorized agents (and their respective agents) of insurance companies. Such an agent does not qualify as an advisor or intermediary, but still qualifies as a financial services provider.

The inducement rules in principle apply to firms (whether Dutch or non Dutch) that have a Dutch license to act as a financial services provider (of the categories described above). Although these rules also target the provider of the financial product (eg insurance companies in relation to insurance and banks in relation to

mortgage credit), only advisors and intermediaries are affected. If such advisors or intermediaries are paid by a product provider in breach of the rules, only the relevant advisor or intermediary, as the case may be, can be the subject of sanctions by the AFM.

The scope of the inducement rules also covers EEA (European Economic Area) insurance brokers that have passported their home state license into the Netherlands (to the extent they offer any products that trigger the inducement rules as described above). Such brokers may request the AFM to grant a dispensation if they persuade the AFM that they can reasonably not comply with the rules and that the objectives of the inducement rules are attained in another way.

2.2 Content of current rules

Like the inducement rule for MiFID firms, the inducement rule for financial services providers states that a product provider, intermediary or advisor must not pay or be paid any commission, in relation to intermediating or advising in respect of complex financial products, mortgage credit, payment insurance, funeral insurance and non-life insurance, which does not enable or is not necessary for the provision of the relevant services (commissions that enable or are necessary for the provision of investment services could include custody costs, settlement and exchange fees, regulatory levies or legal fees), other than the following:

- A commission paid to or by the client. From 1 January 2012, such commissions are not even allowed if they are manifestly unreasonable given the nature

and scope of the financial service (although the AFM would not be able to compensate policy holders for any damages, it could impose sanctions on entities breaching this rule).

- One-off fees (*afsluitprovisie*) or continuing brokerage fees (*doorlopende provisie*) in respect of complex financial products, mortgage credit, payment insurance or funeral insurance, paid to or by a third party, where the following conditions are satisfied:
 - the client is informed in a detailed, accurate and understandable manner of the existence, nature and amount of the commission or, where the amount cannot be ascertained, of the manner in which it is calculated (or if the commissions are paid in kind, the market value), before the service concerned is provided and
 - the payment of the commission benefits the quality of the service concerned and does not detract from the financial services provider's obligation to promote the client's interests.
- One-off fees (*afsluitprovisie*) or continuing brokerage fees (*doorlopende provisie*) in respect of non-life insurance, paid to or by a third party, provided that the client is informed in a detailed, accurate and understandable manner of the existence, nature and amount of the commission or, where the amount cannot be ascertained, of the manner in which it is calculated (or if the commissions are paid in kind, the market value), before the service

concerned is provided (from 1 January 2012);

- Promotional gifts with a value not exceeding €100 (per year).

As follows from the above, these inducement rules are similar to the MiFID-based inducement rules as described above, with some small differences. For instance, unlike the MiFID-based rules it is not permitted for financial services providers to merely provide a summary of the essential conditions of the commission arrangements.

From 1 January 2012, authorized agents (and their respective agents) of insurance companies have been made subject to inducement rules. The rules applicable to them are similar to the rules applicable to other financial services providers (see above). The new rules state that authorized agents and sub-authorized agents of insurance companies must not pay or be paid, in relation to their activities as (sub-)authorized agent, any commission which does not enable or is not necessary for the provision of such services, unless the commission is paid to or by a third party, and the payment of the commission does not detract from the insurance company's or the authorized agent's obligation to act in the client's interests. Promotional gifts of a value not exceeding €100 per year are also permitted.

Bonus or turnover-related fees prohibited

The explanatory notes to the latest amendments that became effective on 1 January 2012 mentioned that all bonus or turnover-related fees paid to advisors or intermediaries in non-life insurances would become prohibited. Such prohibition already applied prior to 1 January 2012 to financial services providers that have since

January 2009 been subject to the inducement rules for non-MiFID products, ie advisors and intermediaries in complex financial products, mortgage credit, payment insurance or funeral insurance.

Bonus or turnover-related fees are not linked to specific products, but are a remuneration of financial services providers for attaining a certain volume of products of a certain product provider, eg an insurance company. Such fees might detract from the financial services provider's obligation to promote the best interest of the client, as its sales process could become more product-driven than client-driven. It is peculiar that the most recent inclusion of permitted third-party fees for non-life insurances (as of 1 January 2012, see above) was not combined with a requirement that the "payment of the commission benefits the quality of the service concerned and does not detract from the financial services provider's obligation to promote the client's interests". Such criterion has been in existence since 2009 in respect of third party inducements received by other financial services providers (see above), and the criterion has previously been referred to by the legislator to justify the conclusion that bonus or turnover-related fees were prohibited. However, despite this criterion lacking in the new inducement rule for non-life insurance brokers, a prohibition on bonus or turnover-related fees has previously also been justified by the legislator on the basis of the definition of one-off fees (*afsluitprovisie*) and continuing brokerage fees (*doorlopende provisie*). In this respect, the legislator earlier remarked that these definitions make clear that such fees relate to advisory or intermediary activities in respect of a specific financial product, hence

excluding bonus or turnover-related fees. It is prudent for relevant financial services providers to follow at least one of these reasonings and assume that all bonus and turnover-related fees are in principle prohibited.

As to authorized agents and sub authorized agents of insurance companies, the inducement rule prohibits third party commissions paid to them unless the payment does not conflict with the insurance company's or the authorized agent's duty to act in the best interest of the client. The legislator has confirmed that this new rule affects payments of bonus or turnover-related fees to such authorized agents. In principle payments that incentivise an increase of volume or turnover are considered by the legislator as perverse and unlawful. Any commissions received must reasonably relate to activities performed. Other payments would detract from the insurance company's or the authorized agent's obligation to act in the best interest of the client and are not permitted.

2.3 Proposals for amendments (entry into force by January 2013)

The Dutch Government has announced plans to further amend the inducement rules for non-MiFID products. The first set of amendments entered into force on 1 January 2012, see par. 2.1 and 2.2. The second set of amendments has been announced by the Government in letters to Parliament dated 13 April 2011 and 13 December 2011.

This second set of amendments, which have yet to crystallize, are expected to enter into force by 1 January 2013. The measures would aim to further counteract inducements that are not in the interest of clients.

In this respect, the Minister of Finance has indicated he wishes to introduce a complete ban on third party inducements per 1 January 2013, for the following products:

- complex financial products (excluding MiFID products), eg unit-linked insurances and annuities
- mortgage credit;
- income insurance (eg payment insurance instruments (insuring a borrower against the risks that he cannot pay back a credit) and disability insurance)
- funeral insurance products
- MiFID investment services that are rendered by entities that do not have a MiFID-license due to their exempt status under article 3 MiFID (as implemented in Dutch law).

For the avoidance of doubt, these proposals do not concern the provision of MiFID investment services by banks and investment firms licensed in accordance with MiFID.

The background of this ban on third party commissions is that the Dutch Government wishes advisors and intermediaries to stand alongside their clients and put the interests of their clients on the foreground. Third party commissions are not considered to contribute to this objective.

As part of this second set of proposals, the Minister also intends to require advisors, intermediaries and providers of financial products (other than MiFID products) to make a standardized Key Features Illustration ("KFI") available to their client, which would amongst others include information about the costs relating to the product, eg advisory costs and distribution costs. This would also

imply a separation of product, adviser and distributor charges. The KFI would set out the character and scope of the services to be provided. The Minister has indicated that presumably the KFI would be placed on the provider's or intermediary's website. Such a KFI is currently already required for advisors and intermediaries in complex financial products and mortgage credit, but would from January 2013 also be required for other financial services providers, including the product providers themselves. The KFI would, in case of advisory activities, have to indicate whether such activities may relate to only one product provider or whether they are truly independent by making comparisons between several product providers. The KFI would have to be available on the internet.

As part of the second set of amendments, the Government also plans to introduce new conflict of interest rules for financial services providers, like the equivalent rules that are currently in place for MiFID firms.

Further, the Government intends to introduce a new warning requirement and an appropriateness test, which should be applied by financial services providers in respect of their clients and the (non-MiFID) products to be sold to those clients, in case the client indicates that he or she does not wish to receive advice on the product (execution only).

3. Conclusion

The inducement rules for both MiFID firms and financial services providers in non-MiFID products are the subject of significant debate in the Netherlands. As for MiFID products, the Dutch Government is in favour of banning all third party inducements,

not only in relation to the provision of investment advice and individual asset management, but also in relation to other investment services. Despite the earlier remark by the Dutch Minister of Finance that he could not deviate from the MiFID inducement rules since MiFID concerns maximum harmonisation, he has now mentioned to the Parliament that if the final text of MiFID II would not include a complete ban on third party inducements for all kinds of investment services, he intends to prohibit such inducements anyway on a national level.

The proposals to amend the inducement rules for non-MiFID firms are likely to significantly change the business model of financial services providers. Not only does the Government intend to introduce a complete ban on third party inducements in respect of certain financial products, but disclosure requirements would be increased as well.

For instance, the Government intends to prescribe the disclosure of a Key Features Illustration, which would have to include details about advisory costs and distribution costs, and its use would be mandatory not only for advisors and intermediaries but also for product providers. Furthermore, the Government intends to introduce typical MiFID requirements such as an appropriateness test and conflict of interest rules for non-MiFID firms. As a first step in the process of amendments, advisors and intermediaries in non-life insurances as well as authorized agents of insurance companies have become subject to inducement rules as from January 2012. Additional legislation is expected to become effective by 1 January 2013.

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