Guidelines

Remuneration policies and practices (MiFID)

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Contents

Guidelines on remuneration policies and practices (MiFID)

I. Scope

1. These guidelines apply to:

    a. investment firms (as defined in Article 4(1)(1) of Markets in Financial Instruments Directive 'MiFID'), including credit institutions when providing investment services, UCITS management companies and external Alternative Investment Fund Managers (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); and

    b. competent authorities.

2. These guidelines apply in relation to the provision of the investment services listed in Section A of Annex I of MiFID and ancillary services listed in Section B thereof.

3. These guidelines address situations where services are provided to retail clients, and should also be applied, to the extent they are relevant, when services are provided to professional clients.

4. These guidelines apply from 60 calendar days after the reporting requirement date referred to in paragraph 11.

II. Definitions

5. Unless otherwise specified, terms used in the Markets in Financial Instruments Directive have the same meaning in these guidelines. For the purposes of these guidelines, the following definitions apply:

competent authority	An authority designated by a Member State under Article 48 of the Markets in Financial Instruments Directive to carry out the duties provided for under MiFID.
Markets in Financial Instruments Directive	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.
MiFID Implementing Directive	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

senior management	The person or persons who effectively direct the business of the investment firm (see Article 2(9) of the MiFID Implementing Directive).
relevant person(s)[1]	Persons who can have a material impact on the service provided and/or corporate behaviour of the firm, including persons who are client-facing front-office staff, sales force staff, and/or other staff indirectly involved in the provision of investment and/or ancillary services whose remuneration may create inappropriate incentives to act against the best interests of their clients. This includes persons who oversee the sales force (such as line managers) who may be incentivised to pressurise sales staff, or financial analysts whose literature may be used by sales staff to induce clients to make investment decisions. Persons involved in complaints handling, claims processing, client retention and in product design and development are other examples of 'relevant persons'. Relevant persons also include tied agents of the firm.[2]
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. It can be either financial (such as cash, shares, options, cancellations of loans to relevant persons at dismissal, pension contributions, remuneration by third parties e.g. through carried interest models, wage increases) or non-financial (such as career progression, health insurance, discounts or special allowances for car or mobile phone, generous expense accounts, seminars in exotic destinations, etc).
quantitative criteria	For the purpose of these guidelines, primarily numeric or financial data that is used to determine the remuneration of a relevant person (e.g. value of instruments sold, sales volumes, establishment of targets for sales or new clients, etc.).
qualitative criteria	For the purpose of these guidelines, primarily criteria other than quantitative criteria. It can also refer to numeric or financial data used to assess the quality of the relevant person's performance and/or service to the client e.g. return on the client's investment, very low number of complaints over a large timescale, etc.

6. Guidelines do not reflect absolute obligations. For this reason, the word 'should' is often used. However, the words 'must' or 'are required' are used when describing a MiFID or MiFID Implementing Directive requirement.

[1] Although "relevant person" is defined in Article 2(3) of the MiFID Implementing Directive, the focus of these guidelines is the remuneration of all persons involved in the provision of investment and/or ancillary services - in particular, those who can have a material impact on the service provided and on the conduct of business risk profile and/or who can influence corporate behaviour.
[2] See paragraph 49, page 16, of CESR, Inducements: report on good and poor practices, 19 April 2010 (ref. CESR/10-295). That paragraph states that "under Article 23 of MiFID an investment firm is fully and unconditionally responsible for its tied agents. In these circumstances compensation of the tied agent can be seen as an internal payment within the firm which does not fall within the inducements rules".

III. Purpose

7. 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. On the one hand, remuneration policies and practices should ensure compliance with the conflicts of interest requirements set out in Articles 13(3) and 18 of MiFID; and on the other hand they should also ensure compliance with the conduct of business rules set out in Article 19 of MiFID.

8. ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID conflicts of interest and conduct of business requirements in the area of remuneration by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.

IV. Compliance and reporting obligations

Status of the guidelines

9. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.

10. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

Reporting requirements

11. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, stating their reasons for non-compliance where they do not comply or do not intend to comply, within two months of the date of publication of the translated versions by ESMA to MiFID_remuneration606@esma.europa.eu. In the absence of a response by this deadline, competent authorities will be considered non-compliant. A template for notifications is available from the ESMA website.

12. Financial market participants are not required to report whether they comply with these guidelines.

V. Guidelines on remuneration policies and practices (MIFID)

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

13. When designing or reviewing remuneration policies and practices, firms should consider the conduct of business and conflicts of interest risks that may arise. A firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties (which should include the avoidance of conflicts of interests created by those remuneration policies and practices) and conduct of business risk management obligations, in order to ensure that clients' interests are not impaired by the remuneration policies and practices adopted by the firm in the short, medium and long term.

14. Remuneration policies and practices should be designed in such a way so as not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests (for example in the case of self-placement[3] or where a firm promotes the sale of products that are more lucrative for it), to the potential detriment of clients.

15. Furthermore, 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 conduct of business or conflict of interest requirements.

16. When designing remuneration policies and practices, firms should consider all relevant factors such as, but not limited to, the role performed by relevant persons, the type of products offered, and the methods of distribution (e.g. advised or non-advised, face-to-face or through telecommunications) in order to prevent potential conduct of business and conflict of interest risks from adversely affecting the interests of their clients and to ensure that the firm adequately manages any related residual risk.

17. When designing remuneration policies and practices, firms should ensure that the ratio between the fixed and variable components of the remuneration is appropriate in order to take into account the best interests of their clients: high variable remuneration, based on quantitative criteria, can increase the relevant person's focus on short-term gains rather than the client's best interest. Furthermore, the remuneration policies and practices 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.

18. When assessing performance for the purposes of determining variable remuneration, firms should not only take sales volumes into account as this can create conflicts of interest which can ultimately result in detriment to the client. When determining the remuneration for tied agents, firms may take the tied agents special status (usually as self-employed commercial agents) and the respective national specificities into consideration.[4] However, in such cases, firms' remuneration policies and practices should still define appropriate criteria to be used to assess the performance of relevant persons. Such assessment should be based on qualitative criteria encouraging the relevant persons to act in the best interests of the client.

19. Where remuneration is, in whole or in part, variable, firms' remuneration policies and practices should define appropriate criteria to be used to align the interests of the relevant persons or the firms and that of the clients. In doing so, firms should consider qualitative criteria that encourages the relevant persons to act in the best interests of the client.[5] Examples of qualitative criteria include compliance with regulatory requirements (especially conduct of business rules and, in particular, the review of the suitability of instruments sold by relevant persons to clients) and internal procedures, fair treatment of clients and client satisfaction.

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[3] The practice of firms selling proprietary financial instruments – such as common equity shares, preference shares, hybrid securities and debt (in either the firm itself or in another entity within the same group) – to their own clients.

[4] Specific rules for the remuneration of tied agents could, for example, be derived from national implementing acts of the COUNCIL DIRECTIVE of 18 December 1986 on the coordination of the laws of the Member State relating to self-employed commercial agents (86/653/EEC).

[5] In line with CRD III principle G that states *'where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the credit institution and when assessing individuals performance, financial as well as non- financial criteria are taken into account'.*

20. In determining the performance of relevant persons, firms should also take into account the outcome of their activities in terms of compliance with the conduct of business rules and, in general, with the duty to care about the best interests of their clients.

21. 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, and implemented by appropriate functions to promote effective corporate governance. Senior management should be responsible for the implementation of remuneration policies and practices and for preventing and dealing with any relevant risks that remuneration policies and practices can create.[6]

22. Furthermore, firms' remuneration policies and practices should adopt and maintain measures enabling them to effectively identify where the relevant person fails to act in the best interests of the client and to take remedial action.

23. Relevant persons should be clearly informed, at the outset, of the criteria that will be used to determine the amount of their remuneration and the steps and timing of their performance reviews. The criteria used by firms to assess the performance of relevant persons should be accessible, understandable and recorded.

24. Firms should avoid creating unnecessarily complex policies and practices (such as combinations of different policies and practices, or multi-faceted schemes, which increase the risk that relevant persons' behaviour will not be driven to act in the best interests of clients, and that any controls in place will not be as effective to identify the risk of detriment to the client). This may potentially lead to inconsistent approaches and hamper proper knowledge or control of the policies by the compliance function. Appendix I of the guidelines hereto sets out illustrative examples of remuneration policies and practices that create risks that may be difficult to manage due to their complexity, and strong incentives to sell specific products.

25. Firms should have written remuneration policies, which should be periodically reviewed.

26. Firms should ensure that the organisational measures they adopt regarding the launch of new products or services appropriately take into account their remuneration policies and practices and the risks that these products or services may pose. In particular, before launching a new product, firms should assess whether the remuneration features related to the distribution of that product comply with the firm's remuneration policies and practices and therefore do not pose conduct of business and conflicts of interest risks. This process should be appropriately documented by firms.

27. Examples of good practice:

- The variable part of the remuneration paid out is calculated and awarded on a linear basis rather than being dependent on meeting an 'all or nothing' target. In some cases, the firm decides to pay out the variable remuneration in several tranches over an appropriate time period, in order to adjust for and take into account the long term results.

[6] In line with CRD III principle C that states *'the management body in its supervisory function of the credit institution adopts and periodically reviews the general principles of the remuneration policy and is responsible for its implementation'*.

- A firm has fundamentally changed the components of variable remuneration. The variable component of the remuneration is now based on qualitative criteria and more closely reflects the desired conduct of the employees to act in the best interests of the clients.

- References used in the calculation of variable remuneration of relevant persons are common across products sold and include qualitative criteria.

- In the case of an open-ended investment with no investment term, the remuneration is deferred for a set number of years or until the encashment of the product.

- Payment of variable remuneration may be aligned with the investment term or deferred in order to ensure that the product sold does in fact take into consideration the final return of the product for the client and, where applicable, an adjusted award of variable remuneration is made.

- Employees are paid in relation to both volume of products sold and effective return of these products for the client over an appropriate timeframe. In this instance, the assessment of financial data is used as a measure of the quality of the service provided.

28. Examples of poor practice:

- A firm has started offering advisers specific additional remuneration to encourage clients to apply for new fund products in which the firm has a specific interest. This often involves the relevant person having to suggest that their clients sell products that they would otherwise recommend they retain so they can invest in these new products.

- Managers and employees receive a large bonus linked to a specific product. As a result, the firm sells this specific product irrespective of the suitability of this product for the clients addressed. Warnings from the risk manager are ignored because the investment products generate high returns for the firm. When the risks that had been identified occur, the products have already been sold and the bonuses have already been paid out.

- The variable component of the total remuneration is based only on volumes sold, and increases the relevant person's focus on short-term gains rather than the client's best interest.

- Relevant persons engage in frequent buying and selling of financial instruments in a client's portfolio in order to earn additional remuneration without considering the suitability of this activity for the client. Likewise, rather than considering the suitability of a product for a client, relevant persons focus on the sale of products that have a short investment term in order to earn remuneration from re-investing the product after the short term.

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

29. Firms should set up adequate controls for compliance with their remuneration policies and practices to ensure that they deliver the intended outcomes. The controls should be implemented throughout the firm and be subject to periodic review. 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.

30. Where potential or actual client detriment might arise as a result of specific features in remuneration policies and practices, firms should take appropriate steps to manage potential conduct of business and conflict of interest risks by reviewing and/or amending these specific features, and set up appropriate controls and reporting mechanisms for taking appropriate action to mitigate potential conduct of business and conflict of interest risks.

31. Firms should ensure that they have appropriate and transparent reporting lines in place across the firm or group to assist in escalating issues involving risks of non-compliance with the MiFID conflicts of interest and conduct of business requirements.

32. The compliance function should be involved in the design process of remuneration policies and practices before they are applied to relevant persons. In order to control the design of remuneration policies and practices and the approval process for these, the compliance function should verify that firms comply with the MiFID conduct of business and conflicts of interest requirements, and should have access to all relevant documents. 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.[7]

33. The firm's remuneration policies and practices should also benefit from the full support of senior management or, where appropriate, the supervisory function, so that necessary steps can be taken to ensure that relevant persons effectively comply with the conflicts of interest and conduct of business policies and procedures.

34. When outsourcing the provision of investment services, firms should have in mind the best interests of the client. Where a firm is seeking to use another firm for the provision of services it should check that the other firm's remuneration policies and practices follow an approach consistent with these guidelines.

35. Examples of good practice:

- A firm uses a wide range of information on business quality monitoring and sales patterns, including trend and root-cause analysis, to identify areas of increased risk and to support a risk-based approach to sales monitoring, with particular focus on high performing relevant persons. The firm ensures that results of such analyses are documented and reported to senior management together with proposals for corrective action.

- A firm uses information-gathering tools to assess the investment returns received by clients over various timelines in respect of the investment services provided by relevant persons who are remunerated by variable remuneration. Good practice would be established when an assessment of this information, rather than a sales target, is a factor in the provision of variable remuneration.

- A firm annually assesses whether the information management tools it uses adequately capture the qualitative data required to determine the variable remuneration it pays to relevant persons.

[7] See ESMA 'Guidelines on certain aspects of the MiFID compliance function requirements' [ESMA/2012/388], and the EBA Guidelines on Internal Governance.

- In order to assess whether its incentive schemes are appropriate, a firm undertakes a programme of contacting a sample of clients shortly after the completion of a sale involving a face-to-face sales process where it is not able to monitor recorded telephone sales conversations, so as to test if the sales person has acted honestly, fairly and professionally in accordance with the best interests of the client.

- Top earners and performers are recognised as being potentially higher risk and, as a result, additional scrutiny is given to them; and information such as previous compliance results, complaints or cancellation data is used to direct compliance checking. The outputs have an impact on the design/review of the remuneration policy and practices.

36. Example of poor practice:

- A firm mainly relies on quantitative data as the criteria for assessing variable remuneration.

- A firm fails to monitor, assess or prevent the risks that basing some or all variable remuneration on quantitative data poses.

- Senior management has set various strategic goals for the firm to be reached in a certain year. All goals seem to focus solely on financial or commercial aspects without taking into account the potential detriment to the firm's clients. The remuneration policy will be in line with these strategic goals and will therefore have a strong short-term financial and commercial focus.

- Despite the care taken in designing and assessing remuneration policies and practices, some policies and practices still lead to client detriment, creating risks that need to be identified and mitigated.

37. Appendix I to these guidelines includes illustrative examples of remuneration policies and practices that would create strong incentives to sell specific products and for which firms would therefore have difficulties demonstrating compliance with the MiFID requirements. The conduct of business and conflict of interest risks related to such examples should be taken into account by firms when designing and implementing their remuneration policies and practices.

V.III Guideline on competent authorities' supervision and enforcement of remuneration policies and practices

38. Where competent authorities, through their supervisory activity, find evidence of poor practice in breach of MiFID in relation to these guidelines, they should consider the appropriate action to take.

39. Competent authorities should review how firms plan to meet, implement and maintain their remuneration policies and practices, and how appropriate action is taken to ensure the best interests of the client in this regard.

Appendix I: Illustrative examples of remuneration policies and practices that create conflicts that may be difficult to manage

Certain remuneration features (for example, the basis of pay, running performance-based competitions for relevant persons) involve higher risk of potential damage to clients than others (specifically those that include features which may have been designed to affect the behaviour of relevant persons, especially the sales force). Examples of high-risk remuneration policies and practices that will generally be difficult to manage, and where it would be difficult for a firm to demonstrate compliance with MiFID, include:

1. Incentives that might influence relevant persons to sell, or 'push', one product or category of product rather than another or to make unnecessary/unsuitable acquisitions or sales for the investor: especially situations where a firm launches a new product or pushes a specific product (e.g. the product of the month or "in-house products") and incentivises relevant persons to sell that specific product. Where the incentive is different for different types of products, there is a high risk that relevant persons will favour selling the product that results in higher remuneration instead of another product without appropriate regard to what is in the client's best interests.

    a. Example: A firm has remuneration policies and practices linked to individual product sales where the relevant person receives different levels of incentives depending on the specific product or category of products they sell.

    b. Example: A firm has remuneration policies and practices linked to individual product sales, where the relevant person receives the same level of incentive across a range of products. However, at certain limited times, to coincide with promotional or marketing activity, the firm increases the incentive paid on the sales of certain products.

    c. Example: Incentives that might influence relevant persons (who may be remunerated solely by commission, for example) to sell unit trusts rather than investment trusts – where both products may be equally suitable for clients - because sales of unit trusts pay substantially higher commissions.

2. Inappropriate requirements that affect whether incentives are paid: remuneration policies and practices which include, say, a requirement to achieve a quota of minimum sales levels across a range of products in order to earn any bonus at all is likely to be incompatible with the duty to act in the best interests of the client. Conditions which must be met before an incentive will be paid may influence relevant persons to sell inappropriately. For example, where no bonus can be earned on sales unless a minimum target is met for each of several different product types, this may impact on whether suitable products are recommended. Another example is where a reduction is made to a bonus or incentive payments earned because a secondary target or threshold has not been met.

    a. Example: A firm has relevant persons who sell a range of products that meet different client needs, and the product range is split into three 'buckets' based on the type of client need. Relevant persons can accrue incentive payments for each product sold, however at the end of each monthly period no incentive payment is made if they have not reached at least 50% of the sales target set for each 'bucket'.

    b. Example: A firm sells products with a range of optional 'add-on' features. The relevant person receives incentive payments for all sales, with an additional payment if the client purchases an add-on feature. However at the end of each monthly period no incentive payment is made if they have not achieved a penetration rate of at least 50% of products sold with an add-on feature.

3. Variable salaries where the arrangements vary base pay (up or down) for relevant persons based on performance against sales targets: in such cases, the relevant person's entire salary can become – in effect – variable remuneration.

   a. Example: A firm will reduce a relevant person's basic salary substantially if he or she does not meet specific sales targets. There is therefore a risk that he or she will make inappropriate sales to avoid this outcome. Equally, relevant persons may be strongly motivated to sell by the prospect of increasing basic salary and associated benefits.

4. Remuneration policies and practices which create a disproportionate return for marginal sales: where relevant persons need to achieve a minimum level of sales before incentive payments can be earned, or incentives are increased, the risk is increased. Another example would be schemes that include 'accelerators' where crossing a threshold increases the proportion of bonus earned. In some cases, incentives are payable retrospectively based on all sales rather than just those above a threshold, potentially creating significant incentives for relevant persons to sell particular products in particular circumstances.

   a. Example: A firm makes accelerated incentive payments to relevant persons for each product sold during a quarterly period as follows:

      - 0-80% of target no payments
      - 80-90% of target 50€ per sale
      - 91-100% of target 75€ per sale
      - 101-120% of target 100€ per sale
      - >120% of target 125€ per sale

      This example can also apply where the relevant person receives an increasing share of commission or income generated.

   b. Example: A firm has the same accelerated scale as the firm in example d1, but the increase in payments per sale is applied retrospectively to all sales in the quarter, e.g. on passing 91% of target the incentive payments accrued to date at the rate of €50 per sale are increased to €75 per sale. This creates a series of 'cliff edge' points, where one additional sale required to reach a higher target band causes a disproportionate increase in the incentive payment.