



European Securities and  
Markets Authority

# Final report

Guidelines on remuneration policies and practices (MiFID)





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## **Acronyms**

AIFMD	Alternative Investment Fund Managers Directive
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CRD	Capital Requirements Directive
EBA	European Banking Authority
ESMA	European Securities and Markets Authority
MiFID	Markets in Financial Instruments Directive
UCITS	Undertakings for Collective Investment in Transferable Securities

## I. Overview

1. ESMA's Consultation Paper (CP) 'Guidelines on remuneration policies and practices (MiFID)' (Ref: ESMA/2012/570) was published on 17 September 2012. The consultation period closed on 7 December 2012.
2. ESMA received 46 responses, of which 6 were confidential responses. All non-confidential responses have been published on ESMA's website.
3. ESMA also received the Securities and Markets Stakeholder Group's (SMSG) 'Advice to ESMA' on that CP (dated 16 November 2012, ref: ESMA/2012/SMSG/69). This has also been published on ESMA's website.<sup>1</sup>
4. This final report sets out the feedback statement to the CP, which provides an analysis of responses to the consultation (including the SMSG advice), describes any material changes to the technical proposals set out in Annex V of the CP (or confirms that there have been no material changes), and explains the reasons for this in the light of feedback received.
5. Section II below sets out the feedback statement, and Annex I contains the full text of the final guidelines.

### *Next steps*

6. The guidelines in Annex I will be translated into the official languages of the European Union (EU), and published on the ESMA website. The application and reporting requirement dates set out in Annex I will start to run from the date of publication of the translations.

## II. Feedback statement

### *General*

7. A definition of "remuneration" for the purposes of these guidelines has been added to the 'Definitions' section of Annex I hereto.
8. The main issues raised by respondents centred around the following topics:
  - i. Ratio between fixed and variable remuneration; tied agents versus third parties (including meaning of "appropriately balanced").
  - ii. Proportionality.
  - iii. Consistency with other remuneration guidelines and initiatives.
  - iv. Outsourcing.
  - v. Use of the term "relevant person".

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<sup>1</sup> See <http://www.esma.europa.eu/system/files/2012-smsg-69.pdf>.

- vi. Overlap with the ESMA compliance function guidelines.
  - vii. Transitional requirements/deadline (including possible conflicts with national law).
9. ESMA also notes the strong support from the SMSG for the adoption of these guidelines, in particular its statement that: “*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. ... 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. ... 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.*”
10. The main areas that the SMSG suggested for further consideration included:
- i. 100% variable remuneration should be subject to risk assessment by the firm, and close monitoring by supervisors;
  - ii. the importance of enforcement in the area of remuneration (where supervisors find evidence of poor practice in breach of MiFID, enforcement action should follow);
  - iii. more examples for non-financial criteria;
  - iv. the European Commission text from its Impact Assessment for the recast MiFID<sup>2</sup> (as noted in the CP) should be included in the guidelines;
  - v. including a statement that firms should address potential conflicts of interest of sales managers if they play a significant role in business quality monitoring of own staff;
  - vi. conflicts that arise where firms sell their own shares to their own clients (‘self-placement’<sup>3</sup>).
11. ESMA has addressed the SMSG points (i) and (ii) above in paragraphs 13-14 and 34-35 (below) respectively. On SMSG points (iii), (iv), (v) and (vi) above, ESMA:
- has included an additional example at paragraph 19 of Annex I hereto, as well as a definition of qualitative criteria in the ‘Definitions’ section of Annex I hereto;
  - has included a guideline (at paragraph 15 of Annex I hereto) to the effect that where firms’ remuneration policies and practices link remuneration directly to the sale of specific financial in-

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<sup>2</sup> See “Review of the Markets in Financial Instruments Directive (MiFID)”, European Commission, 8 December 2010, page 70: “Conflicts of interest requirements ... includes the remuneration of sales forces and the structure of incentives for the distribution of financial products. The Commission services consider that the framework for addressing conflicts of interest within MiFID is still appropriate to prevent failures in the sales process provided that it is consistently applied across Europe. The key element of this framework is the management and the avoidance of conflicts – not just disclosure. While the framework also addresses circumstances in which the disclosure of conflicts of interest might be necessary, this is a measure of last resort and not a means for managing conflicts of interest. For instance, it would be very difficult for a firm which creates strong incentives for its sales staff to sell certain products, e.g. through internal bonus structures, to be able to manage the conflicts of interest thereby created. It is unlikely that such a firm could, in this situation, demonstrate compliance with MiFID.”

<sup>3</sup> 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.

struments or of a specific category of financial instrument, it is unlikely that such firms could demonstrate compliance with MiFID conduct of business or conflict of interest requirements;

- agrees with this view, but has not included a specific statement to this effect, as the definition of “relevant persons” includes such managers (“persons who oversee the sales force”) and ESMA considers this concern is adequately addressed in V.I of Annex I hereto (see also paragraphs 28-29 below); and
- notes SMSG’s concerns in respect of self-placement and has included additional text in paragraph 14 of Annex I hereto.

### *Fixed and variable remuneration; tied agents versus third parties*

12. Respondents generally noted the difficulty in setting fixed and variable remuneration rates, and many noted that the ratio between fixed and variable remuneration should be appropriately balanced, but not fixed by the guidelines. Respondents queried how such ratios could be applied to tied agents, who may be remunerated almost entirely by variable remuneration based purely on sales. Some respondents queried whether clients’ best interests could be met when variable remuneration existed.
13. ESMA notes that the guidelines do not propose fixing the components of fixed and variable remuneration. ESMA considers that variable remuneration does not inherently give rise to any conduct issues, as long as it is structured to encourage the relevant persons to act in the best interests of the client. However, when the assessment of performance for the purposes of determining variable remuneration only takes into account sales volumes, this can create conflicts of interest which can ultimately result in detriment to the client.
14. Therefore, ESMA has made it clearer in paragraph 18 of Annex I hereto that where remuneration is based on sales volumes (as could be the case, in particular, for tied agents), firms’ remuneration policies and practices should 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.

### *Meaning of “appropriately balanced”*

15. Respondents offered views on how the balance should be set, including setting specific percentage splits between fixed and variable and more general ratios involving fixed always being greater than variable. Respondents noted that ESMA should consider the importance of variable remuneration in a business environment. The specificity of how the variable remuneration is determined, rather than considering setting specific ratios, was also noted.
16. ESMA notes that the words “appropriately balanced” should not be understood to mean that the split between fixed and variable remuneration for tied agents is 50/50, or that a 100% variable remuneration would not be possible at all. In order to find the “appropriate balance” between the fixed and the variable components of the total remuneration, firms need to take into account the interests of the firms’ clients when determining the size of the variable component.

### *Proportionality*

17. Some respondents noted that the guidelines did not clearly set out how the proportionality principle would be applied.
18. ESMA has drafted the guidelines with the proportionality principle in mind and therefore firms should apply the guidelines taking into account the nature, scale and complexity of their businesses and the nature and range of investment services and activities.
19. However, ESMA considers that all firms need to manage their remuneration policies and practices with their clients' best interests in mind. ESMA considers that the CP was sufficiently clear on this point, and wishes to reiterate that proportionality has no place in the area of mis-selling.

### *Consistency with other remuneration guidelines and initiatives*

20. Many respondents stressed the need for consistency between these guidelines and other guidelines on remuneration, such as the AIFMD guidelines and the CEBS guidelines. Some of these respondents encouraged ESMA to issue all of its remuneration guidelines in a single consolidated document.
21. The CP (under "Other relevant initiatives") set out how the various remuneration guidelines (CRD III, AIFMD and MiFID) are inter-related. Since the context of each Directive and each related set of guidelines is different, ESMA does not believe that there is a consistency issue here. ESMA considers that these guidelines supplement a cross-sectoral reading of the rules. The overall effect is complementary rather than conflicting.
22. Although some of the remuneration rules in CRD and the CEBS Guidelines need to be applied on a firm-wide basis, the most onerous rules, such as those on deferral, apply only to "members of staff whose professional activities have a material impact on the institution's risk profile" (known as 'Identified Staff'). The term includes "senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm's risk profile". This definition aims to capture all staff capable of posing a material prudential risk to the firm. Under AIFMD the definition of 'Identified Staff' is almost the same as under CRD III, except that it captures individuals who can have a material impact on the risk profiles of the Alternative Investment Fund Managers (AIFMs) or of the Alternative Investment Funds (AIFs) they manage (the AIFMD Guidelines provide some further guidance tailored to the asset management framework on how to identify the relevant staff).
23. These MiFID guidelines, being conduct-focused in nature, target a different population of staff: essentially employees who, directly or indirectly, engage with the firm's clients. As a result, certain individuals, senior management for instance, could be caught by the CRD III and/or MiFID rules if they are capable of posing a prudential risk and creating inappropriate incentives to act against the best interests of the client. This does not give rise to any issues, since the categories of staff noted in paragraph 8 of the CP reflect the type of conduct risks that the MiFID guidelines aim to address, and complement the categories of staff covered by the prudential rules. These guidelines also apply to UCITS management companies and external AIFMs, but only when they provide investment services.

24. ESMA also notes that CRD IV introduces a maximum ratio of 1:1 between the fixed and the variable components of remuneration (and in certain circumstances other ratios may be applied). ESMA considers that this does not prejudice these guidelines: these guidelines will only apply in relation to the provision of investment services and ancillary services of MiFID; whereas CRD IV targets staff whose professional activities have a material impact on firms' risk profile. Where certain individuals are captured by these guidelines (when providing investment services to clients) and CRD IV (due to their role in institutions), the former will apply without prejudice to the latter. Therefore, irrespective of what these guidelines provide, any ratio between fixed and variable remuneration components which is established in CRD IV legislation will apply to that person if he/she is an identified risk taker. In summary, these guidelines, which are based on established MiFID conflicts of interest and conduct of business provisions, complement the CRD IV legislation and the CRD III derived guidelines, and apply without prejudice to the CRD IV itself and the CRD III derived guidelines. They add a conduct of business dimension to the prudential perspective covered by the CRD.

### *Outsourcing*

25. Some respondents suggested that the remuneration provided by firms to an outsourced entity or person or tied agent should be out of the scope of these guidelines. This raised the issue of whether payment by a firm to an entity to provide investment services on its behalf is remuneration or an inducement, and whether remuneration can apply to outsourcing.
26. In paragraph 10 of the 'Overview' section of the CP, ESMA stated that "For the purposes of these guidelines, remuneration consists of 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. Furthermore, 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. In such cases, 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."
27. Having considered whether payment by a firm to an entity to provide investment services on its behalf is remuneration or an inducement, and whether remuneration can apply to outsourcing, ESMA is of the opinion that when outsourcing the provision of investment services, firms should have in mind the best interests of the client and should not use outsourcing to circumvent the MiFID rules (or these remuneration guidelines). Where a firm is seeking to use another firm for the provision of services it should check that the firm's remuneration policies and practices follow an approach consistent with these guidelines.

### *"Relevant person"*

28. Respondents noted that the guidelines have a different meaning for the term "relevant persons" than that of Article 2(3) of the MiFID Implementing Directive<sup>4</sup> (which contains a definition of "relevant person"). Respondents stated that this would lead to confusion.

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<sup>4</sup> 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.

29. The guidelines cover all relevant staff (see paragraph 8 of the ‘Overview’ in the CP) including sales managers. ESMA notes the potential conflict of this terminology with Article 2(3) of the MiFID Implementing Directive but will keep this terminology (as explained in paragraph 8 of the ‘Overview’ section of the CP) for the purposes of these guidelines. In order to make this approach clearer, an explanation in this regard has been added to Annex I hereto at paragraph 5 (see footnote 5).

#### *Overlap with the MiFID compliance function guidelines*

30. Respondents commented that there appeared to be some overlap between some paragraphs of the draft remuneration guidelines and the recently published ‘Guidelines on the compliance function’ (see, in particular, paragraph 32 of Annex I hereto). A few respondents also noted that the ‘Guidelines on the compliance function’ contain no requirements concerning the need for decisions on the topic of remuneration.
31. ESMA considers that there is no real issue here because (i) there is no contradiction between the draft remuneration guidelines and the recently published compliance function guidelines, and (ii) it make sense for all aspects of remuneration to be fully covered in the remuneration guidelines, even if this implies some overlap with other ESMA policy documents. ESMA also considers that these guidelines should set out additional requirements (e.g. on the compliance function) where there is a need for such requirements. However, ESMA has included clear cross-references, through footnotes, to the ESMA compliance function guidelines.

#### *Transitional requirements/deadline*

32. A couple of respondents noted that the transitional period was too short and that a minimum implementation deadline of at least half a year is necessary. Some respondents also stated that in cases where the involvement of employees or employee representatives is required, this deadline should be one year.
33. ESMA is reluctant to change the transitional period as (i) the MiFID rules are already in place, (ii) industry should already be demonstrating compliance with MiFID, and (iii) the guidelines are high-level and generic. ESMA therefore considers that there is a sound basis to maintain the transitional period. ESMA notes that national labour law may constrain timely compliance with these guidelines, but considers that this aspect is covered by Article 16(3) of the ESMA regulation (competent authorities must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance).

#### *Enforcement*

34. The SMSG raised the importance of enforcement and noted that where competent authorities find evidence of poor practice in breach of MiFID, enforcement action should follow.
35. ESMA also notes the importance of close supervisory attention and enforcement in the area of remuneration and, as suggested by the SMSG, has included in Annex I hereto a provision to the effect that supervisors need to supervise appropriately in this regard, and take appropriate enforcement action where they find evidence of poor practice in this regard.

#### *Self-placement*

36. The SMSG highlighted the specific conflicts of interest that arise when financial institutions sell their own shares or other financial instruments (preferred shares, hybrid securities and/or debt) to their own clients (self-placement).
37. ESMA considers that self-placement is rather the context that may give rise to remuneration issues, and is not an issue in itself. However, ESMA has added self-placement as an example (see paragraph 14 of Annex I hereto), together with other examples (such as products that are more lucrative for firms, and products that firms want to dispose of, or off-load).

### *Scope of the guidelines*

38. 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.
39. In relation to services and activities provided through a branch of an investment firm established under a branch passport in another Member State, supervisory responsibility is split between the competent authority of the Member State which has delivered the firm's authorisation (i.e. the home Member State) and competent authority of the Member State where the branch is established (i.e. the host Member State), according to Article 32(7) of MiFID.
40. The competent authority of the host Member State shall assume responsibility for ensuring that the services provided by the branch within its territory comply with the obligations laid down in Articles 19, 21, 22, 25, 27 and 28 and in measures adopted pursuant thereto. The competent authority of the host Member State in which the branch is located shall have the right to examine branch arrangements and to request such changes as are strictly needed to enable the competent authority to enforce the obligations under those Articles. The other MiFID requirements not covered by the above-mentioned Articles are the sole responsibility of the home Member State competent authority (with the exception of the record-keeping provision in Article 13(9) of MiFID). ESMA considers that the host and the home Member State competent authorities should effectively cooperate in order to support each other in the smooth discharge of the respective supervisory duties in relation to branches.
41. 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.

### *Consultation questions, summary of responses, and ESMA feedback*

***We asked: Question 1: Do you agree that firms' 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?***

42. 34 respondents answered this question. There was broad agreement with, and support for, the proposal that firms' remuneration policies and practices should be aligned with effective management of both conflicts of interest and conduct of business risk obligations.
43. A few respondents challenged the assumption that remuneration policies are the only means that can prevent conflicts of interest from adversely affecting the interests of clients, and see no mandatory necessity in aligning remuneration policies and practices with effective conflicts of interest management duties and conduct of business risk management obligations to prevent incentives that may lead relevant persons to favour their own interest, or the firm's interests, to the potential detriment of clients.
44. ESMA has not assumed that remuneration is the only means by which to prevent conflicts of interest from adversely affecting the interests of clients, and agrees that it is important to assess all relevant measures that a firm has implemented in this regard in order to assess whether clients' interests are protected. ESMA considers that these guidelines should be seen in the round, together with other organisational and conduct of business elements, in order to ensure due consideration and protection of clients' interests.

***We asked: Question 2: Do you agree that, when designing remuneration policies and practices, firms should take into account factors such as the role performed by relevant persons, the type of products offered, and the methods of distribution? Please also state the reasons for your answer.***

45. 31 respondents answered this question. The majority of these respondents (27 respondents) agreed that firms should take into account factors such as the role played by relevant persons, the type of products offered and the methods of distribution (with a few welcoming this as an application of the proportionality principle). Several respondents stated that the factors to be considered when designing remuneration policies and practices should be flexible, so as to allow each firm to design according to their business model.
46. ESMA agrees and has inserted the words "but not limited to" in paragraph 16 of Annex I hereto in order to reflect the variety of factors that may arise, but also in order to facilitate flexibility for firms to design remuneration policies and practices according to their business models.
47. Other factors to be taken into account that were suggested by respondents included: the client's profile and existing portfolio, and the timeframe or term of the investment product (so that remuneration is deferred and aligned with the investment horizon in order to avoid excessive risk-taking).
48. ESMA agrees and has added this as an example at paragraph 27 of Annex I hereto.
49. Some respondents (4) questioned whether methods of distribution should be a factor when designing remuneration policies and practices. And a few (3) respondents stated that the differences in dealing with professional clients as opposed to retail clients should be considered a factor when designing remuneration policies and practices.
50. ESMA agrees that methods of distribution should be considered in order to prevent potential conduct of business and conflict of interest risks and has clearly set this out in paragraph 16 of Annex I hereto. With regard to professional clients, ESMA reiterates that although these guidelines principal-

ly 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.

***We asked: Question 3: 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?***

51. 31 respondents answered this question. There was general agreement that the fixed and variable components of total remuneration should be appropriately balanced, and a third of these respondents also noted that firms should be free to set this balance.
52. A number of respondents, while agreeing in principle, also stated that remuneration policies can affect the competitiveness of firms. And a couple of respondents noted that variable remuneration should not be considered 'bad', as it promotes hard work and improves efficiency and good business conduct; and that variable remuneration allows firms to align their interests with that of their employees. One respondent suggested that variable remuneration could be based on growth of the client's portfolio, rather than sales. And a few more stated that an assessment of the conditions attached to the payment of the variable part should also be considered.
53. Several respondents made suggestions on the setting of a specific ratio between the fixed and the variable component. These suggestions were:
  - i. the fixed component should always be greater than the variable component;
  - ii. variable remuneration should be no more than 75% of fixed remuneration, and more active compliance involvement is required where it exceeds 100% of the fixed remuneration;
  - iii. variable remuneration should be set at a maximum of 66% of the total remuneration; and
  - iv. variable should never be more than 50% of total remuneration (and that if the variable is far higher than the fixed, this will lead to greater risk-taking).
54. ESMA agrees that it is up to firms to decide what the appropriate balance between fixed and variable remuneration should be, taking into account their particular circumstances. In making the proposal for the balance to be "appropriate", ESMA had in mind providing a degree of flexibility in deciding the right balance (to facilitate an adjustable alignment with clients' interests), rather than defining a fixed ratio between fixed and variable remuneration, also having in mind that some components of variable remuneration (as qualitative criteria) can align the client's interest with the interest of the recipient of the remuneration.

***We asked: Question 4: 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.***

55. 35 respondents answered this question (although a third of these respondents either referred to their responses to Question 3 or answered Question 3 and Question 4 together, so this section only deals with responses that contained additional information to that already submitted). Respondents generally agreed that the ratio between the fixed and the variable components of remuneration should be appropriate in order to take into account the interests of the client.

56. Further respondent comments noted that:

- i. the ratio of fixed to variable remuneration has a clear impact on the advice offered to clients;
- ii. the variable component should not be too significant compared to the fixed component in order not to create incentives against the clients' best interest;
- iii. setting too high a fixed ratio would result in too high fixed costs, which would make it difficult for the firm to survive in tough market conditions;
- iv. there should be no hard caps on fixed or variable remuneration, and that firms should have the opportunity to justify high variable remuneration;
- v. the fixed component should be sufficient to live on and the variable component should reward performance without creating inappropriate incentives, and therefore a standard fixed ratio cannot be defined in all cases;
- vi. a link between the interests of the client and the ratio between fixed and variable remuneration cannot be established, therefore, client interests is only one element to consider; and
- vii. limiting the level of variable compensation would decrease the opportunity to reduce total compensation where the performance of the business or individuals is below expectations.

57. ESMA has not proposed setting a precise ratio, quantitative threshold, or fixed balance between the fixed and the variable components of remuneration, and notes its proposal that firms should determine, and justify, what the right balance should be, as appropriate.

***We asked: Question 5: 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.***

58. 32 respondents answered this question. Respondents were in broad agreement with the proposal to include non-financial criteria or metrics. Some of these respondents noted that it is already common practice in many jurisdictions and it is an important way to encourage staff to act in the clients' best interest.

59. Some respondents (4), however, said that it should be left to the firm to establish how such non-financial criteria should be assessed and to have the right to introduce other criteria. Of these respondents, some referred to the expensive, subjective and complex nature of assessing non-financial criteria.

60. Some respondents (3) claimed that it should not be mandatory for a firm to take into account non-financial criteria and the requirement is too far-reaching and difficult to implement practically.

61. A few respondents (2) added that there should be a balance between financial and non-financial assessment for staff, and that sales should be the principal criterion to assess sales staff. Other respondents replied that non-financial criteria would have to be used when staff other than client facing staff were considered relevant persons.

62. As mentioned for Question 3 above, ESMA agrees that it is up to firms to decide what the appropriate balance between fixed and variable remuneration should be, taking into account their particular circumstances, and believes that some components of variable remuneration (qualitative criteria) can align the client's interest with the interest of the recipient of the remuneration. By way of clarification, ESMA has included a definition of 'qualitative criteria' in Annex I hereto.
63. Furthermore, ESMA notes that the examples of non-financial criteria provided in the CP (compliance with regulation and internal rules, market conduct standards, fair treatment of clients etc.) were provided as examples and were not intended to be exhaustive or prescriptive.

***We asked: Question 6: 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.***

***We asked: Question 7: Do you agree that senior management should be responsible for the implementation of remuneration policies and practices, and for preventing and dealing with any of the risks that remuneration policies and practices can create? Please also state the reasons for your answer.***

64. 31 respondents answered these questions. There was general agreement 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, and that senior management should be responsible for the implementation of remuneration policies and practices, and for preventing and dealing with any of the risks that remuneration policies and practices can create.
65. A few respondents (2) stated that relevant authorities should be notified of such remuneration policies and intervene where appropriate.
66. Further respondents commented that small businesses may not have supervisory/senior management functions that are separate from the compliance function, and that firms should be allowed to decide which body or department is best suited to approve remuneration policies and practices. ESMA understands these concerns, but has chosen to keep the proposed wording, noting that in the 'Background' section of the CP it clearly states that "when referring to organisational requirements, these guidelines should be read together with the proportionality principle as set out in Article 22 of the MiFID Implementing Directive."
67. Some respondents (6) explicitly disagreed with the proposed guideline. The main reason stated was that the proposed guideline is not compatible with some Member States' company laws and goes beyond the requirements set out in the MiFID legislation. Respondents also underlined that the principle of organisational freedom should be upheld with respect to remuneration practices and policies.
68. ESMA considers that it is important for senior management to take overall responsibility for, if not an active role in, the design and implementation of remuneration policies and practices. ESMA considers that this complies with the responsibility of senior management as set out in Article 9(1) of the MiFID Implementing Directive. Therefore, the relevant guideline in this regard (see paragraph 21 of Annex I hereto) has been kept.

***We asked: Question 8: 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.***

***We asked: Question 9: 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.***

69. 26 respondents answered these questions. The vast majority (24) agreed with the principles stated in the guidelines. Respondents were broadly supportive of the proposal that firms should take responsibility for assessing and managing the risks associated with their products. Some respondents stated that, in some jurisdictions, this is already common practice or is in the process of being introduced.
70. Respondents noted further that:
- i. Organisational measures adopted for the launch of new products or services should take into account the remuneration policies and practices only in cases where remuneration is effectively linked to the launch and setting up of a new product.
    - ESMA does not consider that these guidelines should be limited in this regard.
  - ii. Emphasis could be given to the fact that various company policies (and not only those relating to the launch of new products and those relating to remuneration) must be coordinated with each other beforehand in order to ensure, ex ante, the correct procedural process and organisation of the various activities.
    - ESMA considers that these guidelines should focus on remuneration policies and practices.
  - iii. The guidelines should not prevent financial firms, like any other business, from advertising their products and informing clients of their existence, especially in the case of products which, by their intrinsic characteristics, are available for investment only within a limited time period.
    - ESMA does not consider that the guidelines prevent such practices.
71. Respondents generally agreed that remuneration practices and policies should always be appropriately documented, as this would enable ex-post controls to be performed by the relevant functions.
72. With regard to the examples of good and poor practices included in the draft guidelines, some respondents underlined that it could be more useful as a regulatory measure to improve control measures rather than imposing specific remuneration schemes, and it should be therefore clarified that the examples are not prescriptive.
73. ESMA agrees, but believes the guidelines are already sufficiently clear in stating the examples are “illustrative” and are not prescriptive.

***We asked: Question 10: 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.***

74. 27 respondents answered this question. The vast majority agreed 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.
75. One respondent stated that in its jurisdiction firms are already obliged to review appropriate management information to identify any areas where customers are potentially being treated unfairly.
76. Some respondents, while agreeing that management information systems should be designed and used to help identify major risks, underlined that this principle should be applied in a proportionate way and cannot be relied on to identify all risks.
77. One respondent asked ESMA to clarify how this guideline should be applied in practice.
78. ESMA has set out relevant good and bad practices to illustrate the ways in which it considers firms can/cannot comply with this guideline. ESMA has also clarified how the use of management information should be applied to ensure compliance with these guidelines.

***We asked: Question 11: 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.***

79. 30 respondents answered this question. 24 of those respondents agreed 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. Some of these respondents, however, specified that the proposals should ensure that the rules are implemented proportionately. One of them stated that, given the various size of investment firms and financial institutions, there should be first a cost impact assessment of such a requirement.
80. ESMA has clarified the position in this regard in the ‘*Proportionality*’ section above.
81. Respondents asked ESMA to clarify what is meant by “quality of the service provided to the client” and how the principle included in the guideline should be applied in practice. ESMA has modified the guidelines to clarify the qualitative criteria that firms should consider.

***We asked: Question 12: 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.***

82. 32 respondents answered this question. The majority of respondents agreed that the compliance function should be involved in the design process of remuneration policies and practices before they are applied to relevant staff.

83. However, a few respondents (6 out of 32) stated that the involvement of the compliance function in the development of “relevant policies and procedures within the investment firm in the area of investment services, activities and ancillary services” as well as in the case of material adjustments of these policies and procedures is already covered in the ESMA ‘Guidelines on the compliance function’. ESMA notes this concern and has set out its response in the ‘*Overlap with the MiFID compliance function guidelines*’ section above.
84. Some respondents (3 out of 32), although agreeing with the principles stated in the guidelines, asked ESMA to clarify the type of involvement of the compliance function (for example, limited only to a duty of ex-ante advice or ex-post oversight). ESMA considers that the guidelines are sufficiently clear that the compliance function should be involved in the design of the remuneration policies and practices “ex ante” (i.e. before implementation).
85. Finally, some respondents again stated that proportionality is important because, in many small firms, there may not be a separate compliance function and compliance will be overseen by a director who is responsible for this area. ESMA has clarified its position in this regard in the ‘*Proportionality*’ section above.

***We asked: Question 13: 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?***

***We asked: Question 14: 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.***

86. Approximately half (56%) of respondents answered Questions 13 and 14. Approximately half of those respondents (12 out of 26) agreed that it would be difficult for a firm, in the situations illustrated in Annex I of Annex V of the CP, to demonstrate compliance with the relevant MiFID rules.
87. The respondents that disagreed stated:
  - i. Some of the examples are based on the assumption that investment firms earn the same for all their products and that this assumption does not reflect reality. The differences are reflected in the variable part of the remuneration, which is calculated on the basis of earnings. However, this does not automatically lead to a high risk that employees will recommend products that are not suitable for the client.
    - ESMA considers that, although related, these guidelines on remuneration policies and practices are separate to the provisions on inducements in the MiFID Implementing Directive.
  - ii. The assumption that payment of variable remuneration that depends on the achievement of “minimum sales levels” is automatically problematic is incorrect. All circumstances should be considered. If an employee already receives a high fixed remuneration, then a minimum sales quota that would only result in a comparatively small variable bonus, should not create any conflicts of interest.
    - ESMA does not agree, and has retained the guideline on payment of variable remuneration based on quantitative criteria, and the examples in paragraph 2 of Appendix I to Annex I hereto.

88. Respondents also suggested pointing out in the introduction to Appendix I that the examples have a purely illustrative value and that, although they may be useful in assessing cases that may occur in reality, each situation must be assessed on its own merits and characteristics and associated circumstances. ESMA reiterates that the examples are “illustrative” only.

## Annex I - 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:

<i>competent authority</i>	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.
<i>Markets in Financial Instruments Directive</i>	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.
<i>MiFID Implementing Directive</i>	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.
<i>ESMA Regulation</i>	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.

<i>senior management</i>	The person or persons who effectively direct the business of the investment firm (see Article 2(9) of the MiFID Implementing Directive).
<i>relevant person(s)<sup>5</sup></i>	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. <sup>6</sup>
<i>remuneration</i>	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).
<i>quantitative criteria</i>	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.).
<i>qualitative criteria</i>	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.

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<sup>5</sup> 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.

<sup>6</sup> 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<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup> 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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<sup>7</sup> 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.

<sup>8</sup> 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).

<sup>9</sup> 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.<sup>10</sup>
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.

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<sup>10</sup> 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.<sup>11</sup>
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.

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<sup>11</sup> 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.