

**Vanguard Group (Ireland) Limited**  
70 Sir John Rogerson's Quay  
Dublin 2  
Ireland

**Response to the Central Bank of Ireland's Consultation Paper CP 116 on Intermediary Inducements – Enhanced Consumer Protection Measures ("CP 116")**

To be submitted via email to [consumerprotectionpolicy@centralbank.ie](mailto:consumerprotectionpolicy@centralbank.ie)

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## **1. Introduction**

This submission is made on behalf of Vanguard Group (Ireland) Limited ("**VGIL**") which is the UCITS management company for a number of Irish domiciled funds. VGIL is grateful for the opportunity to provide the Central Bank of Ireland (the "**CBI**") with our views on CP 116.

Following the 2016 Discussion Paper on the Payment of Commission to Intermediaries ("**Discussion Paper**") published by the CBI, we strongly support the CBI's decision to further review and consult with the industry on the practice of intermediaries receiving inducements from product providers for arranging the sale of their products, and the effect that this may have on consumers. We fully support the CBI's proposal that the proposed revisions to the CBI's Consumer Protection Code 2012 ("**Code**") will apply to all intermediaries.

As stated in our previous response to the Discussion Paper, it is VGIL's policy not to pay third parties commission for arranging the sale of Vanguard funds. Instead, we work with fee based investment professionals who appreciate Vanguard's low cost, quality and diversified fund range. We have been a vocal proponent in Europe of banning the receipt and retention of commission by intermediaries, on the basis that in our experience where such prohibitions have been implemented, they have:

- reduced the risk of intermediary conflicts of interest affecting the products that are purchased by/for end investors;
- increased product access and competition, meaning a wider variety of products are available for investors to purchase; and
- increased cost transparency.

The overarching principles underlying the themes arising from the Discussion Paper and the proposals on those themes in CP 116 therefore are (i) the avoidance of conflicts of interest arising from inducement arrangements; and (ii) greater transparency for consumers. VGIL supports the CBI's discussion of these important themes, which we deem critical to the proper functioning of financial markets.

## **2. Background on Vanguard**

The Vanguard Group, Inc. ("**VGI**") began operations in the USA in 1975 and is headquartered in Valley Forge, Pennsylvania, USA. Today the Vanguard group of companies ("**Vanguard**") operate in Europe, the Americas, Asia, Australia and Canada. VGIL, a wholly owned subsidiary of VGI, is the management company for Vanguard's Irish domiciled fund range. Vanguard currently has over \$5

trillion in assets under management, of which, as at 31 December 2017, approximately €106 billion is in the Irish UCITS funds and ETFs that VGIL manages.

VGI is owned by Vanguard's US domiciled mutual funds, which in turn are owned by the investors in those funds. This means that Vanguard's US-domiciled mutual funds are managed with an at cost philosophy, which keeps expenses low, maximising investor returns. VGIL operates with the same intention and focus, which is reflected in our philosophy, policies and practices.

Vanguard's mission is to take a stand for all investors, to treat them fairly and to give them the best chance of investment success. It is our belief that investment success is based on four key principles, being: (a) clear and appropriate investment goals; (b) suitable asset allocation using broadly diversified funds; (c) minimising costs; and (d) maintaining perspective and long-term discipline. As such, Vanguard aims to offer investors the highest value investment products and services available and has an unwavering focus on investor value and costs.

### **3. VGIL's support for a ban on intermediaries receiving and retaining commission payments**

As stated in our 2016 response, we strongly believe that the fund market operates in the best interests of investors where:

- providers compete on the price and quality of their products to secure distribution; and
- intermediaries are not inappropriately influenced by the payment of commission by product providers when providing advice or distributing funds to their customers.

As CP 116 highlights where commission is paid to an intermediary by a product provider, there is a genuine risk that, rather than acting in the best interests of their client, an intermediary will favour those product providers who remunerate the intermediary through the commission payment. We believe that this risk will continue to exist in the absence of a complete ban.

As a result, VGIL strongly advocates for a complete ban in Ireland on the receipt and retention of commission by intermediaries. This view aligns to Vanguard's mission to ensure that all investors have the best chance of investment success, a key part of which we believe is removing conflicts of interest from the distribution chain and minimising investor costs wherever possible. VGIL as a product provider, does not pay intermediaries commission for distributing funds, and would argue that this model allows investors to benefit from lower ongoing charges.

Whilst we do not dispute that increased transparency with regards to commissions can potentially mitigate the adverse impact of product providers paying commissions to intermediaries, we remain strong advocates for an outright ban on the basis that in our view the associated conflicts can only truly be addressed where the payment of commission by product providers to intermediaries ceases to exist. Indeed, we would challenge the premise that such an outright ban will necessarily result in an 'advice gap' and even if this were the case, whether the need to avoid such an 'advice gap' sufficiently outweighs the need to avoid consumers being exposed to real and detrimental conflicts of interest. Currently (and under the CBI's proposal outlined in this Consultation Paper) the risk remains that intermediaries are incentivised to select fund shares that generate high levels of commission from product providers, rather than being motivated by the best interests of the end investor. This is both potentially detrimental to end investors and serves to undermine trust in the financial services industry.



Investor awareness of the commission being paid to intermediaries does not effectively mitigate the risk of remuneration bias that impacts the selection of products by intermediaries. We feel strongly that many investors fail to appreciate that commission payments increase underlying product cost and, therefore, have the potential to act as a drag on their investment potential. Moreover, we would question how the CBI will be able to ensure with fortitude in all cases that inducement arrangements are properly designed to avoid conflicts of interest and promote the best interests of consumers.

#### **4. VGIL's views on avoiding conflicts of interest**

In the absence of an outright ban, VGIL supports the CBI's proposed measures to require firms to avoid conflicts of interest created by poorly designed inducement arrangements and provide greater transparency to consumers. We recognise that the CBI measures proposed in this Consultation Paper proceed on the basis that, in principle, it should be possible to properly design arrangements by which a product provider remunerates an intermediary it has appointed to sell its products so that those arrangements do not conflict with the intermediary's obligations to act in the best interests of its underlying customers.

As this approach relies heavily on industry players to design incentives correctly, we would stress the importance of such arrangements being made clear to the consumer from the outset. We support the CBI's proposal that where consumers receive advice from an intermediary that accepts and retains an inducement, the intermediary should be transparent and clear in communicating that it does not hold itself out as being 'independent'. VGIL agrees with the CBI's interpretation of the term "independent" which appears to be aligned to the MiFID II definition.

We also agree with the CBI's proposal that inducements contingent on achieving targets that do not consider the consumer's best interests (including profit targets, volume targets and business retention targets) should be avoided. We would assert that such arrangements represent a significant possible conflict of interest and as such would need to be sufficiently mitigated with an appropriate level of governance and oversight. All such policies and objectives that, directly or indirectly, concern the turnover, volume of or the profit from the transactions in question should contain defined objective measures to address potential conflicts of interest. Such measures should help oversight by management. Additionally the risk of certain products with higher incentives being promoted over those with lower commission rates could be reduced where sales performance is assessed on an aggregated firm-wide basis, rather than in respect of the sale of specific products.

Mitigation of possible conflicts of interests could also be aided by conflicts of interest policies expressly covering inducements. To aid early identification and prevention of conflicts of interest, a firm's policy should include the following measures, amongst others:

- establishment of organisational procedures for the protection of consumers' interests;
- requirements for acceptance and granting of inducements, as well as related disclosure requirements;
- where the acceptance of inducements paid to the firm is not justified, provision for their onward disbursement to underlying consumers;

- specific requirements on profits targets, volume targets, and business retention targets and their corresponding remuneration; and
- documentation and transparency of linkage between any specified target and associated inducements.

## 5. VGIL's view on the CBI's acceptable inducements

We concur with the CBI that if inducement arrangements are to remain permissible in Ireland, they must be structured to encourage responsible business conduct, fair treatment of consumers and mitigate conflicts of interest. We agree with the proposed revisions to the Code which will seek to establish a level playing field in terms of inducements across the various sectors within the Irish financial services industry. VGIL supports the amendments to the Code to define what the CBI would consider as specific criteria which must be met in order for inducements to be acceptable, namely they must:

- be designed to enhance the quality of the relevant service to the consumer;
- not impair compliance with the intermediary's duty to act honestly, fairly and professionally in accordance with the best interests of the consumer; and
- not impair compliance with the intermediary's obligation to satisfy the suitability requirements set out in Chapter 5 of the Code.

Whilst the CBI clarity on acceptable inducements through the proposed Code amendments is helpful, we would question whether the CBI requirements in this regard are sufficiently clear to be interpreted and implemented, or whether they are drafted at a level that could allow product providers and intermediaries to enter into commission arrangements that arguably meet the above criteria but yet fail to achieve positive consumer outcomes.

The more specificity the CBI can provide as regards what is acceptable, the lower the risk that intermediaries/product providers adopt an unduly permissive interpretation. In this regard, we would encourage the CBI to be guided in its revision of the Code by the more explicit inducements requirements and guidance that exist in respect of Irish MiFID firms<sup>1</sup>. Even then we would contend that further CBI supervision, oversight and guidance will be required to prevent unscrupulous behaviour in firms from seeking to push the boundaries of what is permissible.

In this regard, we consider illustrative the experiences of the UK's Financial Conduct Authority, which considered it necessary to supplement already fairly detailed guidance as to what was an acceptable non-MiFID non-monetary benefit<sup>2</sup> with specific guidance and examples on proportionality and reasonableness<sup>3</sup> in order to prevent firms entering into arrangements that could be technically

<sup>1</sup> See Schedule 5 of the Irish MiFID Regulations 2017:  
<http://www.irishstatutebook.ie/eli/2017/si/375/made/en/pdf>

<sup>2</sup> See FCA Conduct of Business Sourcebook COBS 2.3.14 G to 2.3.16A G  
<https://www.handbook.fca.org.uk/handbook/COBS/2/3.html>

<sup>3</sup> See FCA Finalised Guidance (FG 14-01) on supervising retail investment advice: inducements and conflicts of interest: <https://www.fca.org.uk/publication/finalised-guidance/fg14-01.pdf>



argued to be acceptable, but that in practice were very much designed to influence intermediary behaviour often not to the benefit of end investors.

## **6. VGIL's view on transparency of inducements**

Should the CBI implement the proposed changes in this Consultation Paper, we consider strongly that transparency in disclosure of inducements arrangements will be of the utmost importance. The means and methods stipulated for disclosure need to be agreed and applied uniformly across all sectors to ensure a level playing field as much as possible. As previously stated in our former response, we believe that investors should be able to discern the cost of the services they are paying for, including: intermediary services; the cost of the product; and any administration costs.

We are concerned that the proposed amendments to the Code in this regard may result in disclosures that are not sufficiently meaningful or actionable for consumers. This raises significant concerns for consumers and the fair operation of the intermediary market overall. Vanguard would suggest that the CBI consider a standardised disclosure format, with mandatory fields that must be populated consistently. For example, a fully transparent commission disclosure would potentially include (a) disclosure of amount of inducement/cost of intermediary service in Euro and cents; and (b) cumulative impact of inducement on expected/actual produce return.

As CP 116 highlights, disclosure (if properly executed) can assist a consumer in developing a better understanding of financial products and to make informed decisions concerning financial products. In this regard, VGIL would urge the CBI to take inspiration from the MiFID II inducement provisions with respect to the proposed changes to disclosure and transparency arrangements in the Code. For example, MiFID II has imposed the following enhanced disclosure obligations in respect of MiFID firms:

- methods of payment including third party payments;
- mechanisms for transferring monetary or non-monetary benefits received by the firm;
- where the amount cannot be determined in advance and only the method of calculating is disclosed in advance, the firm must subsequently disclose the exact amount;
- if inducements are ongoing, the firm must report at least annually to clients on an individual basis on the actual amount received or paid; and
- independent advisers and portfolio managers must report on the payments received and transferred to clients.

In comparison to the CBI's proposed Code revisions, which suggest a disclosure in "general terms to the consumer", the MiFID requirements are more specific with regard to the nature and form that these disclosures should take.

## 7. Record-keeping

If the CBI were to go ahead with the proposals it has outlined, we would encourage the CBI to consider the record-keeping requirements under MiFID II with respect to inducements and conflicts of interest (which appear to be more appropriate than those proposed as revisions to the Code).

Under Schedule 5 of the Irish MiFID Regulations 2017<sup>4</sup> as implemented, the legislation outlines some specific recordkeeping requirements with respect to inducements, namely that:

- *Investment firms shall hold evidence that any fees, commissions or non-monetary benefits paid or received by the firm are designed to enhance the quality of the relevant service to the client:*
  - (a) *by keeping an internal list of all fees, commissions and non-monetary benefits received by the investment firm from a third party in relation to the provision of investment or ancillary services; and*
  - (b) *by recording how the fees, commissions and non-monetary benefits paid or received by the investment firm, or that it intends to use, enhance the quality of the services provided to the relevant clients and the steps taken in order not to impair the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client.*

The CBI should consider these enhanced record-keeping requirements under MiFID II and how best these can be best reflected in the proposed Code amendments.

## 8. Conclusion

Regulators across Europe, and globally, are increasingly viewing commission payments from product providers to intermediaries as non-transparent and are taking active measures to either ban this practice outright or significantly increase transparency in respect of the practice. Based on the arguments outlined above and in conjunction with our earlier response in 2016, VGIL believe that the CBI should introduce a complete ban on intermediaries receiving and retaining commission which would:

- reduce the risk of intermediary conflicts of interest affecting the products that are purchased by/for end investors;
- increase product access and competition, meaning a wider variety of products are available for investors to purchase; and
- increase cost transparency

However, in the absence of such a complete ban VGIL would encourage the CBI to appropriately replicate a more restrictive inducements regime as seen in the UK, and to work on increasing the specificity of inducements that the CBI considers acceptable, as well as increased transparency and record-keeping in respect of inducements. We consider that if the CBI adopts these enhanced

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<sup>4</sup> <http://www.irishstatutebook.ie/eli/2017/si/375/made/en/pdf>

measures to effectively mitigate the highlighted risks, the proposals outlined in CP 116 will be more in line with the CBI's overarching goal to protect customers' interests by ensuring responsible business conduct, fair treatment of investors and avoiding conflicts of interest.

Vanguard wishes to thank the CBI for the opportunity to comment on CP 116. For further information in respect of our responses, please contact

