

**BANCA INTESA'S RESPONSE TO
CESR'S FIRST CONSULTATION
ON ITS DRAFT ADVICE TO THE EUROPEAN COMMISSION
FOR IMPLEMENTING LEGISLATION UNDER DIRECTIVE 39/2004**

II part

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A. INTRODUCTION

Banca Intesa welcomes the opportunity to respond to CESR's first consultation on its draft advice to the European Commission concerning possible technical implementing measures (hereinafter the "Level 2 Measures") of the Directive on Markets in Financial Instruments (CE 39/2004, hereinafter the "DMFI").

In accordance with CESR's schedule, this paper deals with best execution (in Section II) and Section III-B of CESR advice on Level 2 Measures. The remaining part of the comments of Banca Intesa on the proposed Level 2 Measures has been already submitted to CESR. We would like to remind that **the general principles referred to in the first set of comments apply also to this second one**: in fact they reflect the general position of Banca Intesa on the DMFI and the Level 2 Measures as a whole.

Banca Intesa appreciates that the topics under discussion in this paper, i.e. best execution and market transparency, should be further analysed in the light of the advice CESR is rendering pursuant to the second mandate granted to it by the European Commission on 25 June 2004.

If this is expedient for the best execution, since it is a special provision detailing the more general obligations under the conduct of business rules, it is all the more necessary with respect to the transparency issue. As all Level 2 Measures on market transparency must be consistent, and the implementing measures on pre-trade transparency (Art. 27 FIMD) are comprised in the second mandate, we strongly suggest CESR to deal with all the implementing measures concerning transparency at the same time.

The 3 month extension granted to CESR by the European Commission with respect to best execution and market transparency is further evidence that the advice on Level 2 Measures on these topics should be drafted together with the response to the second mandate.

Therefore, **the comments herebelow could well be supplemented once CESR has issued its advice pursuant to the second mandate.**

B. SPECIFIC COMMENTS

Section II – Intermediaries

Best execution (article 13(2))

Introduction

Because of its dimensions, Banca Intesa and its group are active in the whole range of investment services, activities and clients. There follows that our comments reflect and strike a tentative balance between different interests. Therefore our response is not tailored solely on a specific line of business: on the opposite it mirrors the concerns of a universal bank.

General comments to the concept paper on best execution

As a starting point, we analyse Article 21 FIMD within the context of the directive; this is indeed a valuable driver for its interpretation and implementation. Article 21 FIMD lies in section 2, “Provisions to ensure investor protection”, of Chapter II, “Operating conditions for investment firms” of the FIMD, alongside with the conduct of business rules (Art. 19 FIMD ff). Such a position is good evidence of the fact that (i) best execution pertains to the relationship between investment firms and clients and (ii) best execution is one of the specific obligations imposed on investment firms by virtue of law in relation to their relationship with clients.

Accordingly, Banca Intesa fully agrees with CESR when it states that the obligation of best execution has to be read as “a more specific requirement” under the general principle according to which investment firms have to “act honestly, fairly and professionally in accordance with the best interests of clients” (Article 19.1 FIMD).

This reasoning leads to the conclusion that, since honesty, fairness and professionalism are elastic concepts **also best execution cannot be translated into absolute terms**. In fact **there is not a best execution**, but there can be several best executions depending on the focus given to the various factors.

Consequently, also the statement that all investment firms must ensure the **best “result”** in our view is **hardly meaningful**. Given that each investor can legitimately give priority to one factor (e.g. price or time) to the other, there cannot be a “best result” in absolute terms.

Also ensuring the best result/best execution **on a case by case basis is only one of the various possible order execution policies**. Indeed the marginal costs to ensure best execution on a case by case basis are likely to be high to such extent that they can well vanish the marginal benefit deriving from an individual handling in a number of cases. There follows that a standardised approach tends to result more cost-effective and overall preferable for many client profiles (e.g. in the case of small retail clients performing standard transactions).

In line with this analysis, Banca Intesa believes that **best execution should identify a mere procedure to be followed by investment firms while executing orders**. The express provision under Art. 21.1 FIMD of the case of “specific instructions from the client” is an *a contrario* proof that execution policies can simply resolve into the formalisation of the procedure followed by investment firms while executing transactions.

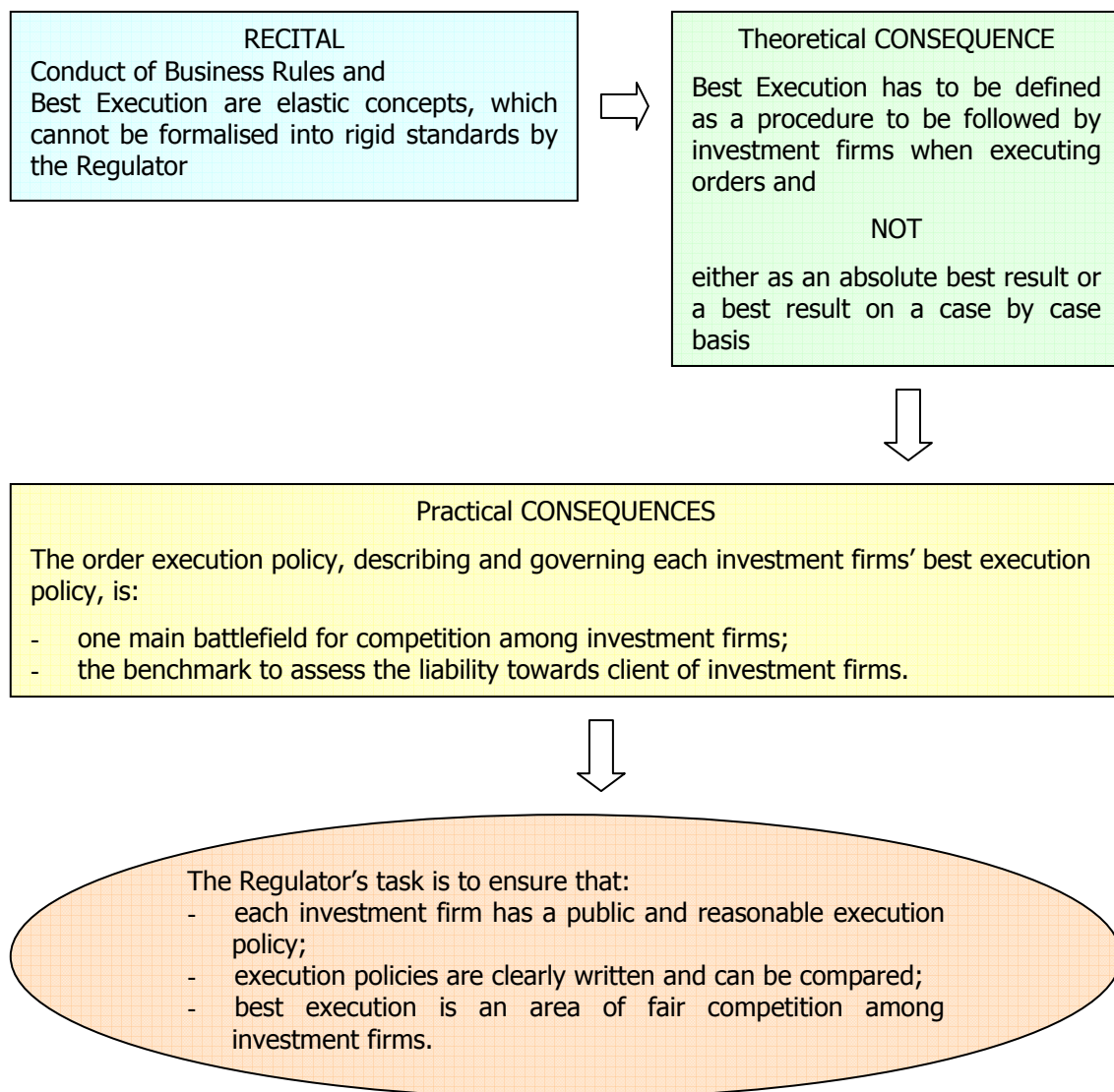
Each investment firm will shape its procedures and average performance in order to satisfy at best the very requirements of its targeted clientele. Accordingly, it is likely that clients will choose investment firms on the basis of their order execution policy, on similar terms as it happens today when they have to choose a bank for the purpose of other banking services (e.g. current accounts and deposits, credit facilities). **Compliance with the chosen**

execution policy will then become the **benchmark** to assess the behaviour and – if it is the case – liability of investment firms.

In fact **best execution** will be one of the “**battlefields**” where **competition among investment firms** will be fiercer. A legal duty to obtain the best result on a transaction per transaction basis would result into a legal limitation of the range of financial services being offered and then of innovation and competition, to the ultimate detriment of clients. For this further reason, **investment firms should not be imposed a best result-oriented best execution**.

From this point of view, what matters is that investors can choose what they want and are put in a condition to compare the various policies. Banca Intesa believes that the **Regulator** should ensure that investors **can compare execution policies**, hence fostering market transparency and fair competition among investment firms, rather than impose a rigid standard of best execution.

This is a graphical representation of the above reasoning:



3.4.1 CRITERIA FOR DETERMINING THE RELATIVE IMPORTANCE OF THE DIFFERENT FACTORS TO BE TAKEN INTO ACCOUNT FOR BEST EXECUTION (21.1)

Introduction

In connection with the issue of assessing and weighting the different factors to be taken into account for the purposes of best execution, there are two preliminary observations stemming from the above general reasoning:

1. Each investment firm must be **able to tailor its execution policy in accordance with its strategies and its goals**; and
2. There must **not** be any **prior discrimination** among investment firms **based on pre-determined contents of the best execution policy**, i.e. all investment firms must be able to compete against each other.

The note under 1. above emphasises the necessary **difference** of treatment **between professional clients and retail clients**. In this respect we wish to underline that the list of factors to be taken into account when an investment firm executes an order pursuant to Article 21.1 is not exhaustive from a retail perspective and should be further specified.

In other terms, we would welcome a CESR's Level 2 Measure detailing the "*any other consideration relevant to the execution of an order*" of Article 21.1 FIMD. This approach could provide **further guidance**, especially to retail banks when they determine and analyse the **various factors relevant for the scope of best execution**, in order to build and then implement an order execution policy. In our view a factor, which should be added to the list of Article 21.1 FIMD, is the possibility to put in place arrangements to manage errors.

Answers to questions for consultation

BOX page 73

Question 1

Banca Intesa agrees with CESR that the relative importance of the factors comprised in best execution policies should be evaluated against the characteristics of the client, of the order and of the trading venue. Nonetheless, the actual application of all three mentioned criteria to the factors should not be imposed in all cases. In fact, this would excessively limit the freedom of investment firms, hence hampering competition. It should be for each investment firm to weight the factors mentioned under Article 21.1 FIMD, thus determining the best execution format applying to each client, each financial instrument and each service provided.

Question 2

We deem that the criteria proposed are exhaustive in determining the relative importance of the factors.

The explanatory text clearly clarifies the meaning of all different factors in respect of the different financial instruments; still it should be supplemented providing guidance on the residual factors mentioned under Article 21.1 FIMD.

Question 3

Banca Intesa believes that, provided that all execution policies make explicit reference to their objective (i.e. type of order) and subjective (i.e. nature of the client) scope of application, it should be left to each investment firm to determine the relative importance of all factors determining how an order is executed. They will depend on the clients' goals together with the strategy and the structure of each investment firm.

Question 4

We believe that this question is not well drafted, since in our view best execution should identify exactly how an order is being executed, without stressing that best execution "determine[s] the best possible result for [...] clients". First, it is our opinion that there is no such thing as an absolute "best possible result" for all clients; and secondly, an investment firm can well offer a result which is not the best one in terms of timing, for instance, but is very well priced, thus being the "best execution" chosen by that investment firm.

3.4.2 TRADING VENUES TO BE INCLUDED IN THE ORDER EXECUTION POLICY (21.2)

3.4.4 OBLIGATION TO MONITOR AND UPDATE THE ORDER EXECUTION POLICY (21.3)

Introduction

Banca Intesa suggests that CESR should recommend in this respect **principles-based rules** as much as possible, inasmuch as its mandate has to be read in conjunction with Article 21.1 FIMD according to which "investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients". This implies that it should **only make sure that investment firms' execution policies are reasonable and fair towards clients**, hence refraining from imposing any additional burden on investment firms other than reasonableness and fairness in the drafting of execution policies. Once the Regulator ensures that all investment firms' execution policies are reasonable and are revised according to the same rules, it will be up to the market to select and "prize" the investment firms with the most performing execution policy.

In addition, by lowering the threshold of prescriptive-ness, Level 2 Measures on best execution can be **applied uniformly** in the European Union. It is commonly recognised that the harmonisation of these important rules is crucial

to the establishment of an efficient and pro-competition regulatory framework. In turn, such framework is the prerequisite to create an integrated single market for financial services.

Answers to questions for consultation

1. Review Requirements

Banca Intesa fully supports the interpretation according to which “article 21 does not require an investment firm to include all trading venues in its execution policy”: as said above, this would be an impractical and unreasonable requirement, leading to the exclusion of small and mid-size investment firms from the market. In turn, we welcome that **investment firms should be requested to act upon their order execution policy**, which should then become the specific set of rules (together with the legal duties and contractual terms and conditions) **against which to determine the liability of investment firms**.

BOX page75

Question 1

Banca Intesa provides all the services included in Section A of the annex 1 of FIMD.

Question 2

Banca Intesa, via its investment firm Caboto S.p.A., has direct access to Borsa Italiana (the Italian stock exchange) and to the biggest regulated markets outside Italy. Generally speaking, the number of markets where Caboto has direct access to, is determined, on a one hand, by the overall costs connected with membership (compared with the business in terms of volume and revenues), and, on the other hand, by the needs of its clients.

A factor to be borne in mind when selecting a trading venue is that the additional costs incurred in connection with the access to that trading venue ultimately fall on clients. For this reason a marginal cost/benefit analysis needs to be carried out before taking the decision to access a certain trading venue.

Gaining access to new trading venues will not be costless: accordingly it will be made only if the new costs are justified by a cost-benefit analysis. Therefore we do not expect to increase the number of markets to which Banca Intesa has direct access immediately after the FIMD is implemented; instead it is likely that we will **re-organize and rationalise the number of venues**.

Question 3

The factors for selecting trading venues should depend (i) on the nature and profile of the **client**, (ii) on his investment **goals** and the **service requested** to the investment firm (e.g. portfolio management, execution only), and (iii) on the features of the **order** to be executed. The execution policy would then be the formalisation of the choice made by the investment firm in relation to the factors affecting execution, such as liquidity, fees, commissions and explicit costs, trading and settlement capabilities.

Question 4

In our experience, the most considered costs when an investment firm evaluates and selects a trading venue settlement are the following ones: transaction fees, settlement costs, and technology-related costs (one-off and running) for implementation, integration and connection.

Question 5

In our view costs are a pivotal factor to be considered when selecting trading venues: each cost (from back office to front office) can really affect a decision on the opportunity to gain access to a trading venue. Anyway, as far as an indirect access is concerned, some costs (such as transaction fees) could be cut down if there is room for negotiation with the party acting as conduit for access.

2. Monitoring requirements

Since best execution is a milestone in the policy of FIMD aimed at protecting investors, Banca Intesa highly welcomes the idea of monitoring order execution policies. We believe that this monitoring should be made:

1. by **all European investment firms according to the same criteria**, to ensure good standards and a true comparability of execution policies;
2. on a **on-going basis** for the information available in real time and on a **periodic basis** for statistic information;
3. **adjusting** the monitoring criteria to the specific features of the client, the financial instrument and the trading venue.

BOX page 76**Question 1**

As far as equity market is concerned, in the domestic market Caboto does not use any specific arrangements to monitor the effectiveness of its execution policy because of the “concentration rule” in force in Italy, according to which all orders have to be executed in the Borsa Italiana RM, to which Caboto is a direct member. Instead, in international markets, where Caboto is not a direct

member, the quality of the execution provided by the selected brokers is constantly monitored by the execution/sales desk.

As far as the OTC bond market is concerned, the monitoring is done in real time while selecting and then trading with the trading venue/market/counterparty in order to provide the best execution at that moment.

Question 3 and question 5

The data available to aid investment firms in their monitoring obligations are basically the market statistics provided by each trading venue.

Question 4

In our view the **frequency of the monitoring of the execution quality should be a matter of free choice of each investment firm**. In particular, the frequency of the monitoring is likely to vary on the basis of the financial instruments and of the service provided. The frequency of such monitoring, in fact, will be one of the elements of choice of clients to select the investment firm which best suits their needs.

Question 6

We believe that execution policies should be more **detailed** than the contractual terms and conditions in force at the moment. Investment firms should be required to disclose their order execution strategies and procedures thoroughly.

3. Timing of venue assessments

Venue assessment is a peculiar type of monitoring and accordingly it should be made along the same principles.

We believe that, in order to reduce costs and to make the information provided more effective, **all trading venues should provide the relevant information in a standardised manner**: this would greatly enhance the **comparability** of information **and** hence the **significance of information**. The further consequence of this standardisation lies in an easier and more precise monitoring of trading venues by all investment firms.

BOX page 76

Question 1

There is not a fixed schedule for the revision of trading venues: the review of the trading venues is necessary whenever the quality of order execution could be affected.

Question 2

In Banca Intesa's view, the re-evaluation of the trading venues is necessary whenever (i) there is a material change at any of the trading venues, at the investment firm or at its execution policy, and (ii) whenever the monitoring

indicates that the trading venues chosen in accordance with the execution policy do not perform in a satisfactory way.

Question 3

The major difficulty an investment firm could face in monitoring and reviewing its execution policy could be the lack of information about the capabilities (in providing the best execution on a consistent basis) of a specific trading venue due to the exiguous amount of orders directed to that trading venue. It is self-evident that **track records or historic information is important** because a firm cannot make judgments taking into account only forward-looking information.

Question 4

At the moment trading venues inform investment firms mainly on costs, fees and commissions. We believe that such information should become as wide as possible, and trading venues should then make investment firms aware also of their strategies, IT systems and any other relevant information concerning their business model.

3.4.3 INFORMATION TO CLIENTS ON THE EXECUTION POLICY OF THE FIRM (21.2)

Introduction

Banca Intesa fully agrees with the CESR's proposal to implement the "appropriate information" of Article 21.3 with the view of helping clients "compare the execution services on offer from different firms and make more informed decisions about the type of service appropriate to their needs" (page 78).

However, we believe that CESR should go a bit further in this respect and focus not only on the information related to the chosen trading venue (e.g. trading venues, procedure for the selection of trading venues and their periodic review, conflicts of interest) but **also on the information on the other significant factors featuring execution policies**. Price, timing, likelihood of execution, percentage of errors and effectiveness of the arrangements to manage mistakes, client order handling policy and all other relevant factors should become part of this information.

Since **comparable information** is the basis for a fair competition among investment firms and a smooth functioning of the market, **full and transparent information on execution policies** should be recommended by the Regulator.

In fact, we believe that it is far more important to ensure that execution policies are understandable, precise and rich in significant data and information, rather than reflect a set of fixed prescriptive rules, which were the best in the mind of the Regulator, on how to execute orders.

Only in the first scenario, in fact, **innovation, efficiency, flexibility and client-tailored service** are preserved and fostered, to the benefit of investors, of the

competitiveness of the European banking industry and of the market as a whole.

Answers to questions for consultation

BOX page 78 – 79

Question 4

Since information needs to be significant, also **its frequency needs to be adjusted to its nature and to the nature of the addressee** (i.e. the client). It could be useful to explain to clients, possibly upon request, the reasons of the chosen frequency. For instance it should be made clear that some trading venues have a higher volatility of prices, and therefore a statistical “correction lens”, such as the standard deviation, should be applied.

Question 6

We believe that the **information concerning all factors determining how an order is being executed** should be part of the information bundle to provide clients with. Trading venues are an important factor, but they should not be over-estimated: they are not the only element determining how well an order is executed. Therefore we suggest that transparency and information falls on all factors taken into account for the purpose of Art. 21 FIMD, such as price, timing, likelihood of execution, percentage of errors and effectiveness of the arrangements to manage mistakes and client order handling policy.

Section III – Markets

B. Market Transparency

Introduction

As an opening remark we would like to underline the link existing between the price formation mechanism and the maturity of a market. It is a commonly accepted economic theory that the deeper and larger a market is, the lesser impact any malfunctioning of the price formation mechanism will have. In fact, if for instance a financial instrument has been sold at a price higher than the average correct price, also because of the lack of pre-trade transparency, such a transaction is likely to be quickly and easily either unwound or “hedged” only in a competitive and liquid market. *Vice versa*, any distortion occurring in a less developed market will possibly resolve into an abnormal increase of the volatility of prices, thus boosting speculation. Furthermore, in the latter scenario, the investor will hardly be in a position to remedy to the loss incurred.

Following a preliminary analysis, we believe that there might be a leverage effect between single transactions executed at non-average prices and their effect on the relevant market. This leverage effect would depend on the degree of development, hence of competitiveness, and therefore of sophistication and maturity, and ultimately of the volatility and liquidity of markets.

The consequence of this reasoning is that, since Level 2 Measures need to fit to all the markets of the European Union, **transparency rules have to be drafted bearing in mind the less mature markets**. The benchmark for transparency rules has to be the market where market self-adjustment mechanisms tend to be less effective and then where external corrective rules are actually more needed.

PRE-TRADE TRANSPARENCY REQUIREMENTS FOR REGULATED MARKETS (ARTICLE 44) AND MTFs (ARTICLE 29)

Introduction

Banca Intesa agrees with CESR on the opportunity to **facilitate the consolidation of pre- and post-trade information**, since this is the most efficient way to convey information and to make it useful, hence maximising the benefits deriving from the costs connected with the provision of such information. However, the consolidation of trading information should be left to the discretion of market users, data vendors and trading venues.

Answers to questions for consultation

BOX 12, page 90

Question 12.1

Banca Intesa agrees with the specific proposal as set forth in the CESR’s advice in relation to pre-trade transparency for regulated markets (RMs) and Multilateral Trading Facilities (MTFs).

Question 12.2

We consider the content of pre trade information appropriate.

Question 12.3

Banca Intesa believes that a pre-trade transparency regime consisting of **5 best bid/offers maximum** should be endorsed by CESR. In fact, in our view this is the best compromise between the need of pre-trade transparency and the necessity to avoid manipulative behaviours, especially in illiquid markets.

Question 12.4

We agree with the “iceberg” - type order exemption (i.e. paragraph 14 page 88), whereas we not share the exemption based on market model (i.e. paragraph 13 page 88). As far as large trades are concerned, we agree with the exemption from the obligation of pre-trade transparency.

Question 12.5

We do **not** support CESR’s proposal to **exempt “crossing systems”** as defined under paragraph 13 in Box 12, because we think that, even though the price of a financial instrument is not determined within a given trading system, still it can be relevant to compare the different prices of that financial instrument and to enhance competition among trading venues.

Question 12.7

Banca Intesa would like to suggest CESR to combine the three alternative methods mentioned under paragraph 15 in order to define the block size exemption.

POST-TRADE TRANSPARENCY REQUIREMENTS FOR REGULATED MARKETS (ARTICLE 45) AND MTFs (ARTICLE 30) AND FOR INVESTMENT FIRMS (ARTICLE 28)

Introduction

From our experience the possibility to obtain and then compare information about transactions, which have already been executed, is essential (i) to allow clients understand how good is the investment service provided by an investment firm and (ii) to put the market in a position to adjust, also in relation to the various trading venues. **Post-trade transparency** is the necessary *pendant* of pre-trade transparency and is as **crucial** as this one.

For this reason Banca Intesa supports CESR’s approach, inasmuch as it aims at making **post-trade information significant, easily accessible and comparable**. Accordingly, we agree with the Level 2 Measures on the content of information to be disclosed and the arrangements to be set up in order to disclose such information, as set forth in Box 13.

In order to allow full comparison, not only within a domestic market, but also between different markets, hence enhancing cross-border transactions and ultimately encouraging the creation of an integrated market for financial services in the European Union, Banca Intesa is convinced that post-trade transparency rules should be applied uniformly in all Member States. This is one of the most striking cases where a mutual recognition regime would resolve into the impossibility to compare information, hence preventing the rule from reaching its scope. This is the reason why we invite CESR to stress the fact that, whatever regime will be chosen, it is **essential** that it leads towards a **maximum harmonisation**.

Answers to questions for consultation

BOX 13, page 95

Question 13.1

We agree with the method of trade by trade information proposed by CESR.

Question 13.2

We support the inclusion of “aggregated information” provided by RMs, by MTFs and by systematic internalisers on the basis of information disclosed under par. 22. AS a matter of fact, Caboto, Banca Intesa’s investment bank, running an Alternative Trading System, already provides all this information with good results. However, we do not see any inconvenience to let market forces (i.e. data vendors) provide it.

Question 13.3

We agree with CESR’s proposal to make post trade information available for two weeks.

Question 13.4

We believe that **no trade** whatsoever should be **excluded** from publication.

Question 13.5

We agree that post trade information shall be made public as close to real time as possible. However, we find the “**one minute rule**” **excessively burdensome**. According to Italian regulations in place at the moment, investment firms are given 14 days to make post trade information public. Therefore the upgrade of IT systems to comply with the proposed new rule would entail huge costs, ultimately falling on the clients. These costs seem to be hardly balanced by the benefits of such prompt publication. In our view an in-between solution is highly desirable.

Question 13.6

All trades, which are above the block size, should be eligible for deferred

publication.

Question 13.7

We believe that the applicable standard for identifying a security should be the **ISIN code**.

Question 13.9

The dissemination and consolidation of information is widely recognised as fundamental to ensure the efficiency of a single European financial market. Therefore **we firmly encourage CESR to start working on this issue in collaboration with the industry and data publishers as soon as possible.**

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