INTESA SANPAOLO

International Affairs

INTESA SANPAOLO RESPONSE TO THE CESR CONSULTATION ON INDUCEMENTS UNDER MIFID

CESR/06-687

EXECUTIVE SUMMARY

The response of the Intesa Sanpaolo Group to the CESR's consultation on inducements under MiFID addresses the following main issues:

- CESR should interpret Level 2 measures so that they specify and regulate only the matters that have not been already been regulated at Level 1. Since the issue of the price of a financial service has already been addressed at Level 1 (Art. 19 (3) MiFID), the concept of inducement should be interpreted so as not to include the price.
- The interpretation of Art. 26 (c) of the Level 2 measure should focus more on the wording of the rule, which makes clear that the rule applies to the examples, but is not limited to them. Hence, Art. 26 (c) should be applicable also to cases other than the quoted examples, provided that the general condition is satisfied.
- In accordance with the architecture and rationale of MiFID, Supervisors should ensure the good functioning of the free market of financial services and of competition rules, rather than assessing the proportionality of fees paid and benefits received, which in turn should be only for market players to evaluate. Therefore, we suggest replacing the criterion of proportionality with those of honesty, fairness and professionalism to determine the requirements on third parties receipts and payments.

GENERAL COMMENTS

The Intesa Sanpaolo Group, created as from 1 January 2007 as a result of the merger of the Intesa Group and the Sanpaolo Group, is the largest banking group in Italy and one of the major players in the European market. It is active in the whole range of banking, investment and financial services, both as a distributor and as an originator of these services.

The Intesa Sanpaolo Group appreciates the transparent process followed by CESR to finalise its Level 3 work to ensure a consistent and coherent interpretation of MiFID and would like to submit the following comments.

A. The residual scope of Level 2 and Level 3 measures

In the architecture of the MiFID and its implementing Level 2 Directive (Directive 2006/73/CE, hereinafter the "L2 Directive") there are three set of rules that need to be read together, so as to understand the scope of each one of them, namely:

a) the provisions on the identification and management of conflicts of interests (Article 13 of the MiFID and Article 21 of L2 Directive), which fall under the organisational requirements and aim at covering "the cases where there is a conflict between the interests of a firm or certain persons connected to the firm or the firm's group and the duty the firm owes to a client; or […]" (Recital 24 L2 Directive);

b) the inducement rules, which apply to the services provided to both retail and professional clients (Article 19 MiFID and Article 26 L2 Directive), are a specification (in fact the only L2 Directive specification) of the general duty of investment firms to "act honestly, fairly and professionally in accordance with the best interests of its clients" (MiFID Article 19, paragraph 1) and hence aim at enhancing investors' protection.

c) the transparency duties concerning the costs and associated charges of the investment services to be provided, which investment firms owe towards retail clients (Article 19, paragraph 3, MiFID and Articles 33 and 29 of L2 Directive), which are a part of the transparency duties of investment firms aimed at enhancing investors' protection.

It is plain that both the transparency provisions referred to under c) and the inducement rules under b) pursue the same investors protection goal. The link between these sets of rules can be found in the MiFID, where paragraph 1 of Article 19 clarifies that the duty of investment firms to act honestly, fairly and professionally implies "in particular, [compliance] with the principles set out in paragraphs 2 to 8", among which there is the duty of transparency under b).

There follows that the specification at level 2 of the general duty to act honestly, fairly and professionally (i.e. the inducements) has to be interpreted in a residual manner with respect to the principles, obligations and requirements already provided for by the level 1 directive (paragraphs 2 to 8 of Article 19 MiFID). In the logic of the Lamfalussy procedure, in fact, implementing measures should specify a general principle only insofar as such principle has not already been clarified by the level 1 directive. For sure, it is not intended that implementing measures overlap and possibly quasi conflict with level 1 provisions by regulating again what has already been regulated by the framework directive.

This reasoning brings to the conclusion that, at least with respect to retail clients, since the issue of transparency with respect to "the price and additional costs" to be paid by a client in connection with a financial instrument has already been addressed

by Article 19, paragraph 3 of MiFID (as implemented by Articles 9 and 33 of L2 Directive), then inducements should interpreted so to address an issue other than the disclosure of fees and commissions already comprised in the price of a given financial instrument.

Therefore, an interpretation that broadens the scope of the inducement provisions so as to include any fee charged or received whatsoever by an investment firm can be seriously challenged on the ground of unduly regulating again what has already been regulated. It is on the basis of this argument that the Intesa Sanpaolo Group suggests that a wide interpretation of Article 26 of CESR exceeds the intended scope of the provision.

B. Article 26 (c) L2 Directive

The Intesa Sanpaolo Group believes that Article 26 L2 Directive should be read so to restrict the application of the disclosure and the quality enhancement tests provided for under letter b) only to the cases where the investment firm dealing with the client receives a benefit from a third party, which actually induces it to act in a manner which impairs its duty to behave honestly, fairly and professionally.

This narrow scope of letter b) is in line with the ratio of the provision and the systematic architecture of the MiFID and the L2 Directive, as it addresses a specific issue, which otherwise could not be covered consistently by all Supervisors.

As a consequence, we believe that CESR should construe Article 26 so that the stringent protection of Article 26 b) is limited to the real "inducements" and all other payments and benefits other than the fees and payments comprised in the price that, in our understanding are outside the scope of Art. 26 (see comments to Question 1), fall under letters a) and c).

Accordingly, we interpret the expression "such as" under Article 26 (c) of the L2 Directive as the introduction of a series of examples and not of a closed list of possible cases. The statement of CESR under § 6, according to which "any items that are not of a type similar to the cost mentions […] are unlikely to fall within this exception", provides for a different interpretation.

We would ask CESR to further elaborate the reasons of this restrictive approach, which also possibly conflicts with the literal wording of the paragraph. As a matter of fact, we believe that the restrictive interpretation of CESR would end up with not allowing a full satisfaction of the general ratio of this letter (c), which lies in the non-application of the stringent requirements for inducements on the fees "which enable or are necessary for the provision of investment services […] and which cannot give rise to conflicts". In fact it could bar the performance of a number of activities, which are necessary for the provision of services but have not been inserted among the examples.

For instance, if an investment firm offers a fixed-interest rate financial product, according to best market practice the investment firm should hedge the interest rate risk by entering into a financial derivative. The investment firm would then pass on the investors of that product the cost of the hedging strategy, bearing in mind that the

overall advantage of the having a fixed-interest rate financial product is greater than the hedging costs. We suggest that the hedging cost is a necessary cost and thus it should fall into Art. 26 (c).

Instead CESR seems to suggest that this cost is not necessary and hence it falls into Art. 26 (b), so that – pursuant to the proposed interpretation of this rule – the Supervisor has to assess the proportionality between the cost and the benefit and can possibly advice the investment firm not to hedge its financial risks, with all the consequences on the risk management policy and the stability of the investment firm or on the range of products offered.

ANSWERS TO THE CESR'S QUESTIONS

General explanation and relationship with conflicts of interest

Question 1: Do you agree with CESR that Article 26 applies to all and any fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client?

As per the legal analysis set forth in the General Comments above, the Intesa Sanpaolo Group is convinced that all fees, which constitute the consideration for a service provided, should fall outside the scope of the rules on inducements. As a matter of fact, investment firms should be allowed to freely determine such prices, provided that they comply with the applicable transparency requirements (Article 33 L2 Directive). In our view, it will then be for market forces to establish whether a service has been properly priced, or not.

It follows that not all fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or an ancillary service to a client should comply with the stringent conditions and tests of Article 26 of the L2 Directive, but only those that are not the consideration for a given service.

For instance, we believe that Regulators should abstain from assessing the level and the fairness of the remuneration charged by investment firms to corporate clients for certain services, such as:

(i) advisory and structuring fees in connection with the issue of securities;

(ii) advisory fees for consultancy on M&A matters, industrial and capital raising strategy; and

(iii) placement fees in connection with the issue of securities or other financial instruments.

To conclude on this point, the Intesa Sanpaolo Group believes that Article 26 of the L2 Directive should only cover those fees that are not the price of an investment or an ancillary service.

Question 2 Do you agree with our analysis of the general operation of Article 26 of the MiFID Level 2 Implementing Directive and of its interaction with Article 21?

On a preliminary analysis we observe that CESR could have further elaborated its interpretation of the relationship between Article 26 and Article 21 of the L2 Directive, in order to make explicit the operational link between these provisions.

Our interpretation of the relationship among these provisions is mainly based on their rationale, which is different. Whereas Article 21 relates to the internal organisation of an investment firm and aims at addressing the more and more frequent issue of the conflicts of interests, Article 26 belongs to the conduct of business rules, which are designated at enhancing the investor protection by setting a standard in the business behaviour of investment firms.

The different subjective scope of these provisions is further evidence of their different nature and purpose.

Albeit the introduction of an effective policy to identify and manage conflicts of interests is beneficial to investors, we believe that the test under Article 21 (e) does not provide for the same level of protection as the conditions under Article 26 b) ii) do. In fact, whereas the conflicts of interest are benchmarked against the potential damage that an investment firm may cause to a client, inducement provisions make reference to an actual behaviour in the interests of the clients. Hence a disclosure under Article 21 e) of an actual damage by definition bars the investment firms' possibility to act in the best interest of the client, so that the second condition under Article 26 b) ii) cannot ever be satisfied.

Conversely, the interpreter has to decide in the case of a potential damage, whether, the investment firm can still be deemed to act in the best interest of the client. There follows that the compliance of an investment firm with the rules on the prevention of conflicts of interests is necessary but not sufficient to ensure investor protection required under Article 26 b ii). In fact, when the disclosure under Article 21 (e) is not adequate to protect the clients, then the L2 Directive has introduced the rule that the investment firm cannot behave in a certain manner *tout court*.

The output of this reasoning is that if the benefit is paid or received by a client, then the investment firm is entitled not to carry out any further test under Articles 21 and 26, given that no conflict of interest can arise and instead there is a normal contractual negotiation. In this scenario, it is for the client to assess the convenience of the deal and the law only provides for a high level of mandatory disclosure by the investment firm (Article 33 L2 Directive).

On the other side, if the benefit is paid or received by a third party, the investment firm has to assess whether the benefit is a proper fee, which is necessary for the provision of the service, or not. In the former case, no further condition is to be met, given that the case is covered by Article 26 (c), which excludes that a conflict of interest can arise. On the opposite, in the latter case a thorough analysis of the potential and actual conflicts of interests and of the overall quality of the investment service has to be performed and – if it appears that the customer's best interest is not satisfied – then the investment firm cannot pay or receive the benefit.

We would invite CESR to confirm that the above development of its concise explanation of the relationship between the conflict of interests rules and the inducement provisions is correct.

We take this occasion to flag to CESR that the Italian and English versions of Article 21 (e) of L2 Directive do not have the exact same meaning, given that the Italian version makes reference to the standard invoicing of the fees, rather than to simply standard fees. The Italian version thus provides for a much stricter wording. We invite CESR to steer a common interpretation of this Article, thus overcoming the imperfections of national translations.

Article 26 (a): items "provided to or by the client"

Question 3: Do you agree with CESR's view of the circumstances in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by a person acting on behalf of the client"?

According to the reasoning set forth in our General Comments, we share CESR's analysis on Article 26 a) of the L2 Directive on the condition that CESR further clarifies that the "fees, commissions or non monetary benefits" under this paragraph do not include the price and all what constitutes the consideration for a service provided or is customary in the market practice. As a matter of fact, we believe that this paragraph should only apply to the non standard and non customary benefits paid by, or on behalf of, a client (for instance, a subscription to Bloomberg offered by the bank to a private client).

If notwithstanding this clear indication, CESR should insist in interpreting the expression "fees, commissions and monetary benefits" under Article 26 a) L 2 Directive so to encompass also the price and the standard and customary fees, the Intesa Sanpaolo Group recommends that further emphasis should be placed on the definition of client. Given the absence of any legislative carve-out, the rule should hence be applied to retail clients as well as to professional clients, since the definition of client in the Level 1 Directive refers both to retail and professional clients. There follows that also the provision of investment and ancillary services at arms' length among investment firms should fall in the scope of Article 26 a), and never under Article 26 b) of the L2 Directive.

Question 4: What, if any, other circumstances do you consider there are in which an item will be treated as a "fee, commission or non-monetary benefit paid or provided to or by the client or a person acting on behalf of the client"?

In our view, a further circumstance where Art. 26 a) could be applied relates to the asset management industry, where in the prospectus two different types of fees are mentioned and disclosed, i.e. a management fee and a distribution fee. The latter type of fee is formally included in the contract and specifically aims at remunerating

one of the firms involved in the investment. According to our interpretation, the management company remunerates the investment firm (i.e. the distributor) on behalf of the client.

We would like to know whether our interpretation is shared by CESR and, should that not be the case, we would like to know the reasons.

Moreover, since legal provisions should not discriminate cases substantially similar but formally different, we would like to know whether in CESR's view a UCITS whose prospectus provides for a management fee and discloses a percentage of that fee that is paid back to the distributor, can fall under Article 26 a).

Article 26 (b): conditions on third party receipts and payments

Question 5: Do you have any comments on the CESR analysis of the conditions on third party receipts and payments?

Interpretation based on the principle of fairness

Intesa Sanpaolo believes that the interpretation of Article 26 (b) should be principle-based rather than rule-based, in order to encompass all possible cases and to follow the fast evolution of financial markets. Given that this Article implements Article 19 (1) of MiFID, there follows that the principles steering the interpretation should be the honesty, fairness and professionalism of the behaviour of investment firms.

Vice versa, the proportionality between the service provided and the inducement should not be a criterion to assess the lawfulness of an inducement. In fact, should that be the case, Regulators and Supervisors would be allowed to ultimately take the place of clients in assessing the economic conditions of a given financial service.

In the light of the liberalisation brought by the MiFID, the Intesa Sanpaolo Group believes that the MiFID and also its L2 Directive should be interpreted so to put clients in a position to make an informed choice and to ensure that no hidden costs and fees are charged to them, then leaving them the choice on the fairness and convenience of economic conditions. According to our analysis of the MiFID, the new framework for financial services intends to ensure transparency and symmetry of information to the maximum extent, so that over-priced and inefficient services are pushed out of the market by market forces and competition. Hence the choice of the European legislator goes towards the strengthening of free market rules, rather than towards the introduction of an external intervention of a third party Supervisor to ensure the proportionality of the fees paid to, or received from, an investment firm.

Furthermore, a proportionality assessment by a financial services Supervisor would partially overlap also with ordinary civil law contractual remedies (e.g. termination of the contract), which aim at addressing the issue of abnormally disproportioned contractual performances. Some coordination among the two sets of rules would then be necessary.

Distribution arrangements

Under § 41 and following of its consultation document CESR suggests that softing and bundling arrangements should be the object of a work programme in order to develop a common approach with respect with these types of arrangements. Since the portfolio manager – broker structure is one of the more common distribution arrangements, the Intesa Sanpaolo Group suggests to deal with distribution agreements together with softing and bundling arrangements, so to develop a comprehensive common approach with respect to distribution.

UCITS

Many examples made under the section under scrutiny make reference to the distribution of UCITS products. The Intesa Sanpaolo Group recommends CESR to carve out the rules on inducements with respect to the distribution of UCITS units for the following compelling reasons:

1. Under Art. 3 (1) second indent of MiFID an optional exemption is provided for entities that are merely active in the distribution of UCITS units. If CESR extended to UCITS units distribution arrangements the restrictive rules on inducements under MiFID, it would give a major competitive advantage to the financial intermediaries which fall outside the scope of application of MiFID thanks to the optional exemption. This would possibly trigger a regulatory arbitrage in favour of more lenient jurisdictions that have implemented the exemption and of financial intermediaries merely dedicated to the distribution of UCITS units;

   The issue of distribution of UCITS units is already under scrutiny by the European Commission, which has published in November 2006 a White Paper on "Enhancing the Single Market for Investment Funds". Hence it would be advisable for CESR to coordinate its interpretation with the vade mecum, which the European Commission intends to publish, in order to elaborate a comprehensive common approach tailored to the mechanics of the UCITS industry. In fact, given the major importance of UCITS as a retail investment tool, we believe that the right emphasis should be granted to the specific features of distribution arrangements of UCITS units and that the European Regulator should not simply apply to UCITS distribution the same rules designed for shares and bonds investments, which have completely different financial attributes, in terms of volatility, maturity and average size per transaction.

   The CESR interpretation of Article 26 should not impair the open architecture distribution model, as opposed to the in-house model, since the former has been recognised by the industry and by the European Commission as innovative and beneficial for investors.

2. The issue of transparency in respect to UCITS has already been addressed by the UCITS Directives, which have introduced the concept of Total Expenses

Ratio (TER). In this respect, CESR has carried out a remarkable work to ensure a consistent calculation and representation of TER across the EU also through the simplified prospectus. Hence we suggest CESR to coordinate any new disclosure obligation with the already existing specific provisions on UCITS, such as the EC Recommendation 2004/384/EC as reviewed inter alia by CESR in July 2005.

Remarks on some examples

We believe that under example n. 3, CESR should expressly clarify the link between the satisfaction of the conditions under Article 21 (e) and of Article 26 (b) of the L2 Directive. In fact, the described behaviour should be prohibited already by applying Article 21 (e), the test under the inducement regulation being redundant.

Question 6: Do you have any comments on the factors that CESR considers relevant to the question whether or not an item will be treated as designed to enhance the quality of a service to the client and not impair the duty to act in the best interests of the client? Do you have any suggestions for further factors?

Making reference to example n. 8, for the sake of clarity and certainty, we would appreciate a further elaboration by CESR on the "exceptional circumstances" referred to under example n. 8.

We do not have any further factor to suggest.

Article 26(b): disclosure

Question 7: Do you agree that it would not be useful for CESR to seek to develop guidance on the detailed content of the summary disclosures beyond stating that:

- *such a summary disclosure must provide sufficient and adequate information to enable the investor to make an informed decision whether to proceed with the investment or ancillary service; and, that*
- *a generic disclosure which refers merely to the possibility that the firm might receive inducements will not be considered as enough?*

We agree on the difficulty, and possibly impossibility, for CESR to draft a general guideline on the disclosure required under 26 (b).

However, we suggest that CESR identifies one or more common hypothetical situations and elaborates a model disclosure for those situations with respect to both the detailed and the summary of disclosure. By doing so, investment firms would have an example to follow as to the format, detail level and accuracy of the two types of disclosure.

Question 8: Do you agree with CESR´s approach that when a number of entities are involved in the distribution channel, Article 26 applies in relation to fees, commissions and non-monetary benefits that can influence or induce the intermediary that has the direct relationship with the client?

We agree with CESR that the only entity to be taken into account for the purpose of inducements is the investment firm with which the client has a contractual relationship. In fact, the rationale of this rule is to protect investors and not to foster the honesty of arm's length business and financial relationships among investment firms.

Tied agents

Question 9: Do you have any comments on CESR's analysis of how payments between an investment firm and a tied agent should be taken into account under Article 26 of the Level 2 Directive?

The Intesa Sanpaolo Group suggests that the fees described in CESR' analysis on tied agents constitute standard and customary fees, which are the consideration for a service provided. Therefore, the above remarks on standard fees, prices and consideration should also apply to those fees.

Question 10: Are there are any other issues in relation to Article 26 and tied agents that it would be helpful for CESR to consider?

We do not see any further issues that CESR could consider.

Softing and bundling commissions

Question 11: What will be the impact of Article 26 of the MiFID Level 2 Directive on current softing and bundling arrangements?

As per our answer under Question 5, we suggest that CESR deals with the topic of softing and bundling arrangements in the context of a comprehensive analysis of distribution. At any rate, CESR should also take into account that these arrangements are overly spread and *de facto* enable the provision of the investment service in a number of situations.

Question 12: Would it be helpful for there to be a common supervisory approach across the EU to softing and bundling arrangements?

Question 13: Would it be helpful for CESR to develop that common approach?

Since the creation of a level playing field and the introduction of a common legislative framework for financial services in the European Union are among the priorities of MiFID, we strongly support a common supervisory approach and a common approach with respect to softing and bundling arrangements. This would, inter alia,

discourage any regulatory arbitrage and enhance the creation of a level playing field among investment firms.

For any further comments or questions, please contact:

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Brussels, 9th February 2007