5 May 2006

Contact person: Mr. E. de Lillo
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Dear Sirs,

Re: Draft Commission Directive implementing Directive 2004/39/EC dated 6.02.06 (the "Draft Proposal") as regards organizational requirements for investment firms: comments on the measures concerning identification, management and disclosure of conflicts of interest (Articles 21, 22 and 23 of the Draft Proposal)

The European Financial Markets Lawyers Group (EFMLG)[1] is a group of legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro.

We are writing with reference to the Draft Proposal implementing the above-mentioned Directive 2004/39/EC ("MiFID"), to the extent that it deals with conflicts of interest in providing investment services (Articles 21, 22 and 23). The EFMLG welcomes a more harmonized regime on the criteria for identification, management and disclosure of conflicts of interest across Member States.

We wish, however, to bring to your attention the significant effects that these provisions as currently written in the Draft Proposal will have on the structure of the European banking industry. As you are aware, this industry is now facing particular challenges consolidating across Europe. In order to assist this important economic policy objective, we believe it is essential to adopt rules which provide for a high degree of legal certainty. Accordingly, we would ask you to consider our concerns surrounding the critical issue of conflicting financial activities and related disclosure requirements in the Draft Proposal, which are discussed in more detail below

We note that the provisions relating to conflicts of interest contained in the MiFID (Article 18) apply both to investment firms and credit institutions when providing one or more investment services and/or performing investment activities

1. Identification and management of conflicts of interest

Criteria for identifying and managing conflicts of interest in Articles 21 and 22 of the Draft Proposal

In our opinion, the <u>criteria</u> provided by Article 21 of the Draft Proposal to investment firms for identifying the types of conflicts of interest are inconsistent with the MiFID Level 1 principles. Article 18(3)(b) directs the European Commission to "…*establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interest of the clients or potential client of the investment firm."* However, the criteria set out in the Draft Proposal are both <u>generic</u> and <u>overbroad</u>. As a result, the criteria do not provide a sufficient yardstick by which an investment firm can calibrate when a client interaction amounts to a conflict of interest. This, by extension, precludes an investment firm from identifying concrete categories of situations potentially detrimental for clients' interest as required by MiFID.

Specifically, each situation listed in Article 21 of the Draft Proposal creates a presumption that the investment firm is acting in a manner that is detrimental to its client's interests, although there may be no evidence to support this presumption either as a general or a specific matter. These situations are very broadly drafted and, short of changing the fundamental legal structure of an investment firm, are endemic to the business of operating an investment firm.

For example, Article 21 presumes that a conflict of interest arises in the following situations: if the investment firm "*is likely to make a financial gain or avoid a loss at the expense of the client*" or if the investment firm "*has an interest in the outcome of a service provided to the client … which is distinct from the client's interest in that outcome*". Such criteria would implicate a conflict of interest in many financial services carried out by an investment firm. Indeed, this potential disparity in outcome is an endemic feature of investment services because the basis of creating a competitive market is that every market participant will have a different view or incentive (*i.e.* clients will be interested in buying financial instruments, whereas the investment firm will be interested in gaining commissions).

Damaging the interests of a client is presumed by the mere fact of a firm potentially making a financial gain or avoiding a financial loss at the expense of a "client" (which term includes

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eligible counterparties, competitors and other highly sophisticated market participants) in the course of providing any investment and/or ancillary services. This applies, therefore, regardless of whether the potential financial gain or avoidance of a loss of the firm at the expense of the client is related to the investment and/or ancillary service in question, or whether there is a contractual or fiduciary relationship between the investment firm and client. That is, an investment firm might be acting as agent to a client on one transaction, but acting as principal with the same client on another transaction at a different time and within a different business area, unknown to the investment firm itself. As an investment firm acting in a principal-to-principal capacity is always positioned to make a financial gain or to avoid a financial loss with a "client", these two independent and entirely distinct transactions with the same client would create a presumption of a conflict of interest.

Moreover, it is unclear why a conflict of interest arises when clients and investment firms carry on the same business: this could involve a general application of the disclosure duties in every inter-banking relationship. Hence, it is arguable whether this broadly applicable situation needs specific protection under the Draft Proposal.

The above interpretation of Article 21 suggests that the universe of potential conflicts of interest is infinite. If the possibilities for conflicts of interests to arise are endless, then so also are the possibilities endless for identifying those conflicts of interest. In short, this open-ended framework means that a firm will never be capable of drawing a circle around its legal and regulatory risk exposure because that risk exposure is unknowable. Unknowable risks create legal uncertainty which, in turn, make informed risk management of an investment firm's commercial activities impossible.

Suggested revisions to the Articles 21 and 22 of the Draft Proposal

To protect investors and to give an investment firm the necessary legal certainty to manage their risks appropriately, the Draft Proposal should only focus on those interests of an investment which derive from investment services and activities <u>different from those specifically agreed or that apply by operation of law between the investment firm and the investor pursuant to its contractual or fiduciary relationship with the services provider</u>. From our point of view, the proposed presumptive situations listed under Article 21 ought to be <u>deleted from the Draft Proposal and replaced with an implementing measure</u> articulating precise and express presumptions that relate to those cases in which actual or potential conflicts of interest arising from different services and activities which <u>pose a clear risk of material damage to the interests of the client</u>.

We would advocate that materiality should be the appropriate test in identifying and managing conflicts of interest obligations, i.e., limited to those conflicts of interest which entail a clear risk of material damage to the interests of the client. We believe materiality goes both to the probability of the risk itself materialising <u>and</u> the degree of damage to the client (*i.e.*, not immaterial). We consider materiality should be the relevant threshold both in terms of likelihood of occurrence between the investment firm and the client and seriousness of impact on the interests of the client.

We likewise believe that materiality should also logically be the criterion applicable for the purposes of managing conflicts under Article 22 of the Draft Proposal. This more discriminating approach would recognize that specific situations may give rise to conflicts of interest that are strictly related to particular types of investment services, while the same situation would <u>not</u> give rise to a conflict of interest for other types of investment services under MiFID. For example, <u>placing financial instruments issued by any company belonging to an investment firm's group</u> creates a conflict of interest, because the financial means collected will be directly or indirectly engaged in the investment firm's activities. On the other hand, dealing the issued instruments during secondary market in full compliance with market abuse regulations would not justify a presumption of an investment firm's conflict of interest.

Moreover, <u>material financing relationships</u> between a bank and an issuer could entail a conflict of interest in the event such bank (or a company belonging to its group) underwrites or places financial instruments of that issuer. In such case the conflict of interest stems from the potential interest of the bank in protecting the issuer's financial position in order to recover its debt. Such an interest cannot arise when the financial instrument issued by the debtor is traded on the secondary market. Likewise <u>significant shareholding relationships</u> between a financial institution and an issuer could imply conflicts of interest situations in relation to underwriting or placing activities in favour of the issuer, due to the shareholder interest in the good financial conditions of the participated company.

In relation to portfolio management and investment advice, such investment services are more critical areas for identifying and managing conflicts of interest due to the <u>greater discretionary power</u> granted by investors to the bank or the financial institutions. As a consequence, a wider range of conflicts of interest situations may arise in providing portfolio management and investment advice than in other investment services.

In consideration of the above, we suggest that the European Commission and the European Parliament continue to refine the European regulatory approach to this issue by adopting more clearly defined criteria in line with the suggestions above. Alternatively, the Draft Proposal could grant competent authorities (with the possible involvement of CESR) the task of precisely regulating the matter at a national level with the cooperation of trade associations. In this regard, precise guidelines could also be prepared by trade associations which could, in turn, be submitted to the relevant competent authorities for approval under CESR monitoring action to ensure a harmonized implementation among Member States.

2. Disclosure of conflicts of interest

According to Article 22, the investment firm is required to disclose the nature and source of the conflict in the event that it is not "*reasonably confident that the measures adopted under its general conflict policy could prevent the risk of damage its clients*". In contrast, a more detailed disclosure is required by Article 22 in relation to the nature of the client. Such a detailed disclosure seems to exceed the stated terms of Article 18 of MiFID and could impinge critically on the management of confidential and price-sensitive information. In other words, a detailed disclosure could directly conflict with an investment firm's duty of confidentiality in relation to information acquired from other contractual relationships.

In light of the above, it would be appropriate to provide, e.g. in the implementing measures for disclosure duties that are consistent with those required by MiFID. Moreover, a clarification would be desirable on the proper conduct of the investment firm when choice of law provisions generate conflicting rules of conduct (*i.e.*, confidentiality, on one hand and disclosure, on the other hand).

We do hope that you find these comments useful and that they could be considered in the context of the on-going discussion at the European Securities Committee level.

With best regards,

E. de Lillo

on behalf of the EFMLG

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