Conflicts of Interest and Inducements

Current as of 28 December 2007

1. Conflicts of interest

1.1. Preamble

The ever-increasing range of activities and services related to financial instruments and financial services offered and performed by banks has increased the potential for conflicts of interest between such activities and the interests of customers.

The requirements of banks established by the Austrian Securities Supervision Act of 2007 and the FMA's IIKV ordinance for the handling of conflicts of interest may be divided into three stages. The individual stages in the management of conflicts of interest required under the regulations can be characterised by the key words *detection*, *prevention*, and *disclosure*, with relevant organisational precautions being taken in all stages.

Banks therefore need to take all adequate precautions to identify any conflicts of interest occurring in the performance of services or ancillary services in connection with financial instruments and prevent such conflicts through adequate, particularly organisational and administrative actions or, if required, clearly disclose them to the customer. On the one hand, such conflicts of interest may arise between themselves, including their management, their employees or brokers bound by contract or other persons directly or indirectly associated through control and their customers or, on the other hand, among their customers.

In accordance with the GoC, the compliance officer's task is to ensure that the statutory provisions regarding prevention or disclosure of conflicts of interest are observed by the bank, its executives and employees.

The requirement to handle conflicts of interest should not be interpreted as the absolute prevention of the occurrence of any conflicts of interest as such, since it would simply not be possible for credit institution to comply with such prevention requirements given the diversity of business areas and customers. MiFID itself made it clear that it is a matter of preventing conflicts of interest that harm customer interests, as defined in Art. 18 MiFID. Therefore, adequate measures must be implemented. To assess the adequacy of measures, size and organisation of the respective credit institution as well as the type, scope, and complexity of its business shall be taken into account. The requirement to use adequate measures to prevent conflicts of interest from affecting customers shall also entail measures that are capable of preventing the occurrence of conflicts of interest, such as the restriction of the flow of information within the credit institution.

1.2. Identifying conflicts of interest

In particular, the following constellations and behaviours may constitute conflicts of interest that are liable to prejudice the customer's interests:

If the bank or a relevant person (sec. 1 no. 29 Securities Supervision Act), an agent bound by contract or any other person directly or indirectly associated through control with the bank:

- at customer's expense generates a financial inducement or avoids a financial loss,
- has an interest in a service provided on behalf of the customer or a transaction performed on behalf of the customer, which runs counter to the customer's interest,
- has a financial or other incentive to prioritise the interests of another customer or another group of customers over the customer's interests,
- performs the same business activities as the customer (as in case of inter-bank transactions, a conflict of interest does not have to be assumed as a matter of principle),
- has currently received or will receive in the future an inducement in the form of money, goods, or services from a person other than the customer in respect of a service performed on behalf of the customer in addition to the usual fee or charge.

Under sec. 2. of the GoC, the compliance officer's task is - by providing relevant information and instructions - to enable the relevant departments or employees to recognise conflicts of interest and, if required, arrange for the notification of the compliance officer[1]. The identification and handling of specific conflicts of interest remain the task of the relevant divisions and employees, but shall be monitored and, if required, enforced by the compliance officer.

1.3. Handling conflicts of interest

Section 35 of the Securities Supervision Act of 2007 first of all requires that effective and comprehensive guidelines regarding the handling of conflicts of interest be set down in writing and implemented permanently. This involves any form of conflicts of interest resolution in a way that aims to and is suitable to prevent the occurrence of conflicts of interest and prevents such conflicts of interest from affecting individual customers. When setting down such principles, a credit institution's involvement in a group and possible resulting interests of conflict must be taken into account.
Sections 1.5 and 1.6 set forth the individual procedures and measures to be initiated.

1.4. Disclosure of conflicts of interest

Where organisational or administrative arrangements made by the credit institutions in accordance with section 3 to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to customer interests are prevented, the credit institution shall clearly disclose the general nature and/or sources of conflicts of interest to the customer before undertaking business in his name. The disclosure of conflicts of interest is no alternative to measures for the management of conflicts of interest and hence does not exempt from meeting the obligations of reolving conflicts of interest. Rather, the disclosure of any not fully resolvable conflict of interest is the inevitable result of the general limits of prevention policies and thus quasi the last resort in the handling of conflicts of interest. Such disclosure may on a case-by-case basis also take place upon the explicit request of the compliance officer.

Disclosure to the customer shall be made on a permanent data carrier and shall be sufficiently detailed, bearing in mind the knowledge and experience of the customer to enable the customer to make sound decisions with regard to the financial services affected by such a conflict of interest. Furthermore, such disclosure to the customer shall take place prior to performance of the transaction in question. Notwithstanding all disclosure duties, banking secrecy and the relevant provisions of data protection law shall be observed.

1.5. Written rules for handling conflicts of interest

Every credit institution shall adopt a written conflicts of interest policy, setting down an effective strategy for the handling of conflicts of interest in line with its size and with the complexity of its business and shall consistently apply such policy.

If the credit institution is part of a group, such rules shall also take into account all facts that may cause a conflict of interest because of the structure and business activities of other group members.

These written rules shall also set down any possible facts with regard to the credit institution's special financial services, under which a conflict of interest exists or may occur that could significantly prejudice the interests of one or several customers.
Likewise, procedures and actions to be taken to control such conflicts of interest shall also be set down.

The following actions and instruments may be considered to handle conflicts of interest:

– The separation of business areas along possible lines of conflict and the restriction or control of the flow of information between these (areas of confidentiality). In so doing, an efficiently

[1] What is meant here are not the minor or irrelevant conflicts of interest without the potential of prejudice to the customers or personal conflicts of interest between employees and customers, but conflicts of interest (also of organisational or structural nature) that are liable to cause actual damage to the customer and which are to be included in the conflict register or which form the basis for measures taken in the context of the conflict surveillance list.

established and monitored *prevention* of the information flow has as its consequence the exclusion of any horizontal attribution of knowledge between separated business areas and the protection of persons responsible for order acceptance and execution against any conflicts of interest arising either from within the credit institution's or from the customer's sphere. By preventing the flow of information there is also no conflict of interest due to vertical attribution, i.e. due to attribution of knowledge to the top management.

– Omission of one or several conflicting transactions. This simplest of all conflict solution options is only available to the bank, however, if it recognises any conflict potential before entering into relevant obligations and if no other commitments exist. In this case, however, the bank shall not be prevented from selecting the transaction that is profitable for it.

– In cases of specific conflicts of interest, in particular such caused by shortages (e.g. incomplete allocation), the strict application of the priority principle is recommended (i.e. the customer's interests always take priority over the bank or its employees) or partial execution of orders.

The compliance organisation shall ensure that these effective strategies are prepared in writing for all relevant areas and shall monitor compliance with all resulting provisions and periodically review the efficiency and expediency of the strategies.

1.6. Measures to be taken in conflicts of interest cases

1.6.1. Reporting conflicts of interest

Conflicts of interest or the justified suspicion of a conflict of interest shall be reported without exception to the compliance officer, who shall document such notification and record the time, contents, reports, conflict of interest as well as the measures taken. Such recording may on a case-by-case basis also take place upon the explicit request of the compliance officer.

- By definition, reportable conflicts of interest include such that are based on insider information or other compliance-relevant information. Employees and relevant persons who have such information at their disposal shall report them without delay to the compliance officer.
- Similarly, any transactions which are suspected of prejudicing a customer's interests due to a conflict of interest shall be reported by employees and relevant persons in advance to the compliance officer.
- The simultaneous or immediately subsequent involvement of relevant persons in the performance of services under the Securities Supervision Act shall also be reported if such involvement could not be prevented but may affect proper conflict management.

1.6.2. Register of conflicts

The compliance officer shall maintain a strictly confidential register of conflicts, which is known in its entirety only to the compliance officer and which, if required, is supplemented using other information systems such as mandate databases or insider lists. The register of conflicts shall be based on an analysis of the credit institution's actual business areas as well as the resulting potential conflicts of interest, on the one hand, and on the recording of facts that may cause relevant conflicts of interest, on the other (such as specific loan applications, advisory mandates, supervisory board mandates, big orders, (co-) lead functions in case of offerings, analyses), major business relationships (particularly in the area of mergers & acquisitions, etc.) as well as major investments of the credit institution. If the credit institution wishes to enter into new business relationships or make investments with a conflicts of interest potential, they shall be subjected to a preliminary "conflict check". If the transaction is concluded or the investment is made, they shall be added to the register. In addition, any other change with regard to entries in the register shall also be reported to the compliance officer as the body keeping the register and processed accordingly.

1.6.3. Decision regarding identified conflicts of interest

The compliance officer shall decide independently but in the spirit of the statutory provisions and of the internal guidelines approved by him regarding the handling of conflicts of interest whether or not action is necessary in addition to the measures taken by the business area for the respective conflict. If such action is necessary, the compliance officer shall decide on any additional measures to resolve such a

conflict or shall bring about a decision. If required, he may involve internal or external experts in the process. This shall be documented. No inappropriate influence on the compliance officer's decision shall be exercised and no person shall be simultaneously or subsequently involved in potentially conflicting transactions if such involvement may prejudice adequate conflict management.

1.6.4. Exchange of information

There shall be no exchange of information between persons whose activities may trigger a conflict of interest if this exchange of information is liable to prejudice the interests of one or several customers. If such an exchange of information is unavoidable for work-related reasons, the compliance officer shall be notified in advance, also about the contents. In particularly sensitive cases (especially in investment banking), such talks shall be attended by the compliance officer. Otherwise, the provisions regarding areas of confidentiality shall be observed.

1.6.5. Conflict monitoring list

Transactions resulting in a conflict of interest between the credit institution and/or its employees on the one hand and customers on the other hand or between various customers shall be included in a conflict monitoring list and the further course of the transaction as well as the persons involved shall be monitored by the compliance officer. It is for the compliance officer to delete relevant transactions from the conflict monitoring list.

A credit institution may use the opportunity to keep existing registers and lists together with the ones mentioned here as one organisational unit if this does not frustrate the purpose of the regulation.

1.6.6. Independence

Persons involved in several activities associated with a possible conflict of interest shall perform these activities with a degree of independence that is suitable for the size and activities of the credit institution and the risk of prejudicing customer interests.

1.6.7. Simultaneous / consecutive performance of services by one person

To the extent possible, the credit institution shall take adequate measures – in particular a separation of functions – to prevent employees and relevant persons from providing securities services or ancillary services at the same time or directly after each other in a potentially conflicting manner or their involvement in such services. If prevention is not possible, the implementation shall be monitored in an adequate manner by the compliance officer.

1.6.8. Monitoring of employees

The compliance officer shall monitor employees and relevant persons acting on behalf of customers or providing services on behalf of customers with a view to potential conflicts of interest, by using a monitoring system for instance.

1.6.9. Remuneration

Remuneration of persons may not be directly related to the remuneration or generated revenue of other persons, whose activities are in a conflict of interest with the activities of the former. In particular, this concerns sales, proprietary trading, research, issue, M&A and asset management.

1.6.10. Inappropriate influence

The bank shall take adequate organisational precautions to prevent anyone from exerting inappropriate influence on the manner in which another person executes transactions related to securities or ancillary services with potentially conflicting interests. Such precautions shall be updated regularly, and adherence shall be monitored by the compliance officer. The assessment benchmark shall be the credit institution's respective applicable organisational chart representing the areas responsibility and discretionary powers which shall be made available to the compliance officer in the respective amended version.

Regulations regarding the acceptance of gifts shall serve to prevent any inappropriate external influence.

1.6.11. Customer information

Please see sec. 1 sub-para. h and in Appendix 1 to sec. 40 Securities Supervision Act of 2007.

2. Inducements

2.1. Safeguarding customer interests

2.1.1. With regard to the performance of services in the interest of all parties, credit institutions shall refrain from paying or accepting charges, fees and any gifts other than in monetary form (hereinafter generally also referred to as "inducements") if the type or amount of such inducements are liable to prejudice customer interests for the benefit of the credit institution's own interests or the interests of third party market participants. Customer payments to the credit institutions and gifts presented to the customer shall be excluded. Internal allocations of sales commissions from product margins in the credit institution and bonus schemes are not considered inducements.

2.1.2. Such inducements shall be permitted only if all of the following conditions have been met:

- Prior to the provision of the relevant securities or ancillary service, the existence, type and amount of such an inducement or – if the amount cannot be determined – the type and manner of calculating the amount or bandwidths shall be disclosed to the customer in a comprehensive, accurate and understandable manner, and

- generally, the payment or provision of the inducement is designed, i.e. at least with regard to specific customer and/or product groups, to improve the quality of services provided to customers, and

- the bank shall not be affected in its duty to act in the customer's best interest.

2.2. Improving service quality

2.2.1. This "quality improvement outlay" is to be taken as an abstract concept and hence shall be interpreted as the objective to improve the quality of a specific service. In is always an *ex ante* assessment by the credit institution. Therefore no *ex post* proof of any specific quality improvement shall be required. This shall be assessed based on the following criteria, including but not limited to the following:

- If payments are primarily made by the bank to third parties (e.g., external asset managers) to compensate such third party for the management or brokerage fees not granted because of direct payment of the customer, such payment shall primarily be considered as a remuneration for services, also in case of sales-related payments. This shall not constitute any preferential treatment of the credit institution to the detriment of the customer.

- If credit institutions receive inducements from issuers of financial instruments which are shown as standard market brokerage or sales commissions, this shall also constitute payment for a service provided by the credit institution and not as preferential treatment of the credit institution at the customer's expense.

- The acceptance of what is termed "portfolio-based commissions" by credit institutions shall be prohibited if the credit institution nevertheless supports the customer in accordance with the customer's interests and if the funds received as portfolio commissions are at least in part applied or used to improve know-how and service quality for the respective financial instrument to the customer's benefit.

- Inducements such as portfolio-based commissions, which are used to develop or maintain efficient and high-quality infrastructures for the acquisition and disposal of financial instruments, may also be suitable to improve service quality.

2.2.2. The acceptance of an inducement by a credit institution in connection with investment advice or general recommendations shall in any event be suitable to improve the quality of investment advice given to customers if such advice or recommendations are given without prejudice in spite of the acceptance of such inducement. The above shall not rule out the improvement of the quality of services provided to customers when inducement are accepted in investment brokerage. Suitability for the improvement of quality may also mean that the relevant service would not have been provided without such inducement.

2.2.3. A special case is that of payments made by an investment company to investment brokers involved in sales. This case shall constitute compensation for brokerage services, without which such brokerage would not have taken place. This must be obvious to the customer, however, or disclosed to him. Generally, the same shall apply to inducements, without which the financial instrument or product could not be offered to the customer.

Any fees and charges that make the securities service possible or are necessary for this service shall not be considered inducements. In particular, they include remuneration for the keeping of financial instruments in safe custody, for processing transactions or for the use of trading centres, regulatory costs or statutory charges.

2.2.4. The provisions of the "Quality Standards of the Austrian Investment Fund Industry" (Qualitätsstandards der österreichischen Investmentfondsbranche, nos. 27 and 28 of the June 2005 version) shall apply to investment fund management companies and custodian banks.

2.3. Disclosure

The key provisions of the agreements regarding inducements may be disclosed to the customer in summarised form. Upon the customer's request, however, the bank shall be required to disclose further details. The summarised disclosure – which may cover several groups of financial instruments – does not necessarily need to include individual amounts or percentages; as a rule, information on total allocations in absolute amounts or percentages or information about a bandwidth are in compliance with the disclosure requirement. If at the time of disclosure it is not possible to determine the scope of an allocation, the method of calculation can be disclosed.

2.4. Reimbursement of expenses incurred by the credit institution

Direct performance-related payments – such as custody fees, processing and trading centre fees, management charges or statutory changes – accrue because of the business relationship; according to the credit institution's GTCs they are usually borne by the customer without constituting a conflict of interest.