

**IPMA, ISMA and ISDA Joint Response to FESCO Consultative Paper: Implementation of Article 11 of the ISD: Categorisation of Investors for the Purposes of Conduct of Business Rules .**

Executive summary

This is a joint response to FESCO by the International Primary Markets Association (IPMA), the International Securities Markets Association (ISMA) and the International Swaps and Derivatives Association (ISDA).

The Associations welcome FESCO's attempts to reach agreement on a common categorisation of investors for the purposes of the application of conduct of business rules. We particularly welcome the acknowledgement by FESCO that the full range of investor protection rules need not apply to those investors with sufficient knowledge and experience to assess the risks they face and that it is important to avoid over-regulation. Our members think this especially important in a cross-border context, where interprofessional business is still, despite the existence of the Investment Services Directive, systematically subject to double regulation.

Given the very short consultation period, we have not prepared a detailed commentary on the paper, but we do have some important comments summarised as follows, and set out below in more detail, on how we think the paper could be improved.

- *Flexibility*

Ideally, under the overarching principle of know your counterparty, service providers and their clients should mutually agree what level of investor protection rules is appropriate. This is of course particularly appropriate in the case of sophisticated counterparties. Having guidelines or detailed criteria for deciding whether or not a counterparty should be treated as professional is useful, provided that they recognise that in reality the line between professional and non-professional is in practice fluid and furthermore that parties can vary the terms of their relationship by contract. We find the FESCO suggestion of two distinct categories of investor therefore rather too rigid and would argue that it suffers from two main failings.

First, the presumption should surely be that a sophisticated investor such as the treasury department of a large corporate dealing regularly in, say, interest rate swaps or Euro Commercial Paper (ECP) should be treated as a professional unless they agree otherwise with the service provider. As the proposal stands, the presumption is reversed and the cumbersome procedure for a corporate to opt to be treated as a professional means that few will in practice do so.

Second, it surely cannot be right that a sophisticated corporate treasury department which does not opt for treatment as a professional should then be subject to the full set of conduct of business rules designed for retail investors. In other words, there is in practice a third type

of counterparty, that of what might be called sophisticated investors, which depending on circumstances should fall into either the full professional category or else a new intermediate one, but not the retail residual category. We therefore take issue with the FESCO statement that the conduct of business regime for professionals is an exceptional regime an exception to the application of standard conduct of business rules which aim to ensure adequate protection for the less sophisticated investors. The standard regime applicable to a largely wholesale market such as, for example, the swaps or ECP market, should surely be the appropriate interprofessional one.

- ***Rules applicable to inter-professionals business***

Another related, essential point, as noted by FESCO itself, is that the success of any conduct of business regime rests on the content of the rules that apply as well as on the categorisation of investors. In this respect, we welcome the agreement by FESCO that a few general principles and a limited number of standards should apply to inter-professional relationships. This is important. It makes little sense to differentiate between professional and non-professional investors but then apply the same, detailed rules. As noted above, we also think it essential to allow appropriate rules to apply to sophisticated investors who do not wish to be treated as professional and who opt into the second category; full retail protection rules would be inappropriate. We would also welcome a further consultation by FESCO on what type of common or harmonised principles might be applied across the EU to wholesale business.

- ***Territorial application***

Whilst a common definition of professional investors will be of great benefit, FESCO's proposals will not, however, resolve the problem of overlapping and conflicting rules affecting cross-border business. The best way of addressing these issues is to recognise the logic that the Member State from which the firm conducts its business with sophisticated investors is best placed to implement rules of conduct and supervise them. ISDA has prepared a separate paper on this issue for discussion in the European Commission's Forum group on the ISD which argues that for genuine interprofessional business the ISD points to the application of conduct of business rules being a state of origin (home state) responsibility (this paper is attached).

- ***Implementation***

After consultation, implementation of the proposals should be prompt, transparent and broadly based. EU legislation is not necessary and would delay the process. In particular, implementation should not be limited to a narrow subset of conduct of business rules but should also cover the full range of national rules designed for the protection of investors.

The proposals, if implemented rapidly and consistently across the EEA and amended as recommended above, would represent a very significant step towards an appropriate conduct of business regime for inter-professionals business and provide a much needed boost to the development of Europe's capital markets.

### **Detail**

IPMA, ISMA and ISDA welcome the publication by the Forum of European Securities Commissioners (FESCO) of its paper *"Implementation of Article 11 of the ISD: Categorisation of Investors for the Purposes of Conduct of Business Rules"*. The proposals set out in that paper could potentially represent a very significant step towards a conduct of business regime that fully reflects the requirements of the Investment Services Directive (ISD) "to take account of the professional nature of the person for whom the service is provided".

In practice, the conduct of business rules of a number of Member States do not currently significantly differentiate between the treatment of professional and retail investors. In addition, there is little consistency between the Member States on this issue. This failure by many Member States to apply any meaningful level of differentiation between the rules applicable to business conducted with professional and retail investors means that inappropriate levels of regulation are applied in many Member States to inter-professionals business.

The position is even more difficult where a firm conducts cross-border business. In practice, many Member States seek to apply their conduct of business rules to business conducted with investors resident in their jurisdiction irrespective of where the investment services provider is based (at least if the provider solicits business from those investors). This approach, when combined with the lack of consistency between the rules and the level of differentiation between wholesale and retail investors applicable in the various Member States, means that, in practice, firms face a series of overlapping, inconsistent and potentially conflicting rules in different Member States, particularly when attempting to conduct their business from a single location using the freedom to provide services. This is a serious handicap on the development of an efficient European capital market.

FESCO's initiative could go a long way towards addressing many of these concerns. FESCO's proposed definition of a "professional" should be capable of covering most of the market participants that our members would regard as capable of making their own investment decisions. It will, however, be important to ensure that sophisticated market participants such as large corporates should be treated appropriately. We particularly welcome the recognition by FESCO that the rules should be flexible enough to allow individuals and other "smaller size" investors to waive protections that might otherwise apply, subject to appropriate safeguards.

### **The need for flexibility**

The FESCO paper suggests that the "full range of investor protection rules" will apply to those "large-size entities" (covered by section II.2(a) of the paper), as well as to "small size entities and private individual investors" (covered by section II.2(b) of the paper), who do not agree to waive those rules. This suggests that there will, broadly speaking, be two "tiers" of

rules: one applicable to business with non-professional investors and the other applicable to inter-professionals business (although the FESCO paper suggests that there might be some differentiation in the nature of the rules applied to inter-professional business, at least for specific types of service and transaction).

We believe that this structure fails fully to recognise the diversity of different types of investor and that the concept of a third tier needs to be introduced in some way. This is because it is appropriate to apply the full, detailed set of conduct of business rules to business with large size entities that have not agreed to waive those rules. In practice, this will lead to the application of detailed rules designed for the protection of retail investors being applied to business with large corporations. This is unduly burdensome. It means that national rules will continue to fail adequately to "take account of the professional nature of the person to whom the services are applied". National regulators should not apply the full set of conduct of business rules to business with large size entities, even if the entity has not agreed to a specific waiver.

### ***Waiver procedure***

Section II.2 of the paper appears to envisage a three stage process for obtaining a waiver, namely the request from the investor, the written warning from the firm and the statement in writing from the investor. This is also unduly burdensome and does not accord with the reality of how documentation will be structured to comply with this requirement. It should be sufficient if:

- the investment services provider has given the investor a clear written warning of the protections that the investor will lose if it is treated as a professional investor; and
- the investor has stated in writing to the investment services provider that it agrees to be treated as a professional investor and that it is aware of the consequences of losing those protections.

In any event, we believe that the proposed procedure is unnecessarily burdensome in relation to the large size entities covered by section II.2(a) of the paper. It should be sufficient for the firm to notify the investor that it proposes to treat the investor as a professional investor and of its right to object to this treatment i.e. those investors should be given the opportunity to opt out from treatment as a professional investor (rather than being required to opt-in to this treatment). As the paper stands, we do not see that any sophisticated investor covered by II.2(a) will opt out of the full retail protection regime. This cannot be right if the intention is to move to a more appropriate regime for such investors. They should rather be presumed to be professional or, if they so choose, be treated under some kind of intermediate level of regulation. We would also note that there seems to be an overlap between financial institutions deemed to be professional and those the paper counts as large size investors.

In addition, the paper suggests that investment services providers should be required to take "all" reasonable steps and to obtain "all" necessary documents to ensure that the client meets the requisite tests. This standard appears to be unduly burdensome. It should be enough if the provider has taken "reasonable" steps and has obtained "appropriate" documentation.

Similarly, the paper suggests that firms should take (unspecified) steps to ensure that investors eligible for professional treatment continue to comply with the applicable criteria. It is clearly not practical for firms continuously to keep the status of customers and counterparties under review e.g. in order to check that their financial condition continues to meet the relevant size tests. Firms should be entitled to presume that customers and counterparties continue to meet the relevant criteria unless and until specifically notified by the customer or counterparty to the contrary.

### *Size tests*

ISDA believes that the size tests proposed (EUR 10 million paid up capital or net assets; EUR 100 million balance sheet total) are rather high. A number of member states that already allow firms to treat certain corporate or institutional investor as "professionals" or as sophisticated investors not subject to the full retail rulebook based on balance sheet data use much lower thresholds and should be allowed to continue to do so.

### *Treatment of subsidiaries*

The definition of large size entities should recognise the reality that entities frequently operate through subsidiaries (e.g. specialised financing or treasury companies) that may not themselves meet the tests set out in the FESCO paper. For example, it would be inappropriate to require a firm to treat a specialised financing subsidiary of a major multinational group of companies as a non-professional merely because that subsidiary itself does not meet the size tests set out in the FESCO paper. Thus, we believe that the definition of large size entities should be extended to include members of a group headed by or including:

- Financial institutions;
- Large industrial and commercial corporations;
- Large institutional investors;
- Issuers of listed financial instruments;
- Credit institutions, investment firms and insurance companies.

### *Application of size tests on consolidated basis*

The balance sheet (net assets, paid up capital, and balance sheet total) size requirements applied to large industrial and commercial corporations and large institutional investors should be regarded as being met where:

- the entity fulfils that size requirement on its own;
- the entity is a subsidiary undertaking of another entity that meets that size requirement on its own; or
- the entity forms part of a group of undertakings that meets the size requirement on a consolidated basis.

### *Partnerships and other legal forms of business entity*

The paper uses the term "industrial and commercial corporations" in contradistinction to other types of large size entities. However, this term implies that the particular legal form of the entity is relevant to the determination of whether an entity is a professional. It should be made clear that this expression is intended to encompass any undertaking carrying on a trade, profession or business (including holding companies) regardless of its legal form (e.g. including partnerships or other specialised form of undertakings permitted in many Member States or third countries). Also the category of institutional investor perhaps ought to recognise specifically the existence of other types of investor such as trusts and foundations and their equivalents in the various member states.

### *Small size entities and private individual investors*

We welcome the proposal that entities not meeting the size and other criteria and private individuals should be entitled to waive the protection of conduct of business rules. This correctly recognises that individual and other "smaller" investors can have the requisite experience and understanding to do business without the full protection of detailed conduct of business rules.

However, the paper suggests that the assessment of an investor should include "a test comparable to the relevant aspects (experience and knowledge) of the fit test applied to managers and directors of entities licensed under European Directives in the securities field". It appears to suggest that an individual should only be able to be treated as a professional if he would be eligible to become a director or manager of an investment firm. However, the test of knowledge and experience applied for these purposes is devised for entirely different purposes. As the FESCO paper published earlier this year makes clear, the experience and knowledge tests applied to directors and managers are designed to ensure that they are "able to control and direct the business of the firm effectively". This is simply not a relevant criterion to apply for this other purpose. It is also unclear how this test would be applied to a small size legal entity.

There is no need for this additional requirement. The paper sets out the correct standard when it states that the firm must assess whether "the client is capable of making his own investment decisions and understanding the risks involved".

We would make the following comments on the additional criteria:

- With respect to (a), trading of this frequency (10 per quarter) may be appropriate in relation to cash equity or bond transactions. However, it may well be an unrealistic and inappropriate level of trading in relation to other instruments (such as options and derivatives). In addition, (a) suggests a double test of frequency and transaction volume. No particular standard is set for the required minimum volume of transactions but it need not be set too high given the overarching requirement that the customer is able to understand the risks involved.
- With respect to (b), the proposal should take into account the possibility that the investor might be a legal entity or other undertaking. It should therefore at least cover legal

entities or other undertakings with an equivalent level paid up capital or net assets (and an alternative balance sheet total test should be available). As stated above, it should also cover subsidiaries of such an undertaking and members of groups of undertakings that meet this size test on a consolidated basis.

### **Rules applicable to inter-professional business**

The success of FESCO's proposals is, in any event, critically dependent on the nature of the rules that will be applied to inter-professionals business. The paper suggests that "a few general principles" and "a limited number of standards for certain specific types of services and transactions" will apply to inter-professionals business. Clearly, we believe that the grounds for regulatory intervention should be very limited where it is determined that the investors are able to form their own investment decisions and this applies to sophisticated investors in the lower category as much as to the full professional category.

### **Territorial application**

In addition, the FESCO proposals only go so far to deal with the problem of overlapping, inconsistent and conflicting rules affecting cross-border business. In particular, they clearly contemplate that some rules will continue to apply to inter-professionals business and pending fuller harmonisation, or the development of common standards, these will continue to differ from state to state. In addition, the definition of the perimeter of the inter-professionals regime will inevitably not be exactly the same. Thus, even those firms conducting cross-business exclusively with professionals will continue to have exposures to risk, albeit at reduced levels.

We believe that the best way of addressing these issues is to recognise the logic that the Member State from which the firm conducts its business is best placed to implement rules of conduct and supervise compliance with them i.e. the Member State where the physical establishment from which the business is done is located. The issues associated with the appropriate division of responsibility between host and home states, and some specific proposals, are explored in the attached ISDA memorandum submitted to the Commission in connection with the work of the Forum Group on the upgrading of the ISD.

### **Consultation process**

We welcome the initiative by FESCO to consult on the proposals set out in its paper, although we question whether a one month consultation period is really adequate given the significance of the proposals set out in the paper. We strongly believe that broad, public consultation is an essential part of the regulatory process and should become part of the best practice of all regulators across Europe.

Consultation provides regulators and other policy makers with feedback from the industry, users of financial services and other interested parties on the practical implications of proposals. It also allows interested parties to suggest alternative means of achieving the desired objectives. This is critical if the burden of regulation is to remain proportionate to the benefits it achieves.

Broad, public consultation is even more important in the context of the development of the European single market in financial services. As integration continues, national regulatory

initiatives have an increasing capacity to affect market participants and end users across Europe (and beyond). Regulators need to obtain the broadest possible input if they are to ensure that their initiatives do not create barriers to the integration of the single market. In the past, many national regulators have not publicly consulted on proposed regulatory initiatives or have limited consultation to selected national market participants or trade associations.

FESCO should commit to publication of feedback on the results of its consultation process and its members should commit to public consultation on their proposals for national implementation.

### **Implementation**

After the conclusion of the consultation, implementation of FESCO's initiative must be prompt, transparent and broadly based:

- **Prompt:** There have already been too many delays on the way towards the realisation of the single market in financial services. The Second Banking Co-ordination Directive was adopted in 1989 and the ISD in 1993 and yet significant obstacles remain. The existence of overlapping and conflicting rules has for too long been a major source of uncertainty and expense for firms seeking to exercise their Treaty freedoms. This has damaged both the financial services industry and the direct and indirect end-users of its services. National regulators should act swiftly to do what they can to implement the FESCO proposals. The ISD already requires a differentiation between professional and other investors and member states should take rapid action to enforce this. Where full implementation depends on regulations made by other agencies, this should be identified at an early stage in order to secure the rapid adoption of the necessary measures.
- **Transparent:** One of the barriers to the full realisation of the single market has been the uncertainty as to which national rules apply and their precise content. When incorporating the FESCO proposals into their national regimes, regulators should do so in a way that makes plain how the new inter-professionals regime modifies the existing rules and precisely which rules, if any, apply to inter-professionals business. The industry should not have to rely on generalised statements of support for the broad principles set out in the FESCO paper. Likewise, if there are any significant parts of the national regime that fall outside the inter-professionals regime, then this should be clearly identified - and justified. As already stated, each national regulator should commit to public consultation on its proposals for implementation.
- **Broadly based:** Furthermore, the implementation of the proposals must be broad-based and should not seek to limit their effect solely to a narrow sub-set of the rules that affect the conduct of business of banks and investment firms. In most Member States there are a broad range of rules designed to achieve the objectives set out in Article 11. These include not only conduct of business rules as such, but also rules on advertising, solicitation and marketing, prospectus registration requirements, etc. Member States should bear in mind that the requirement of the ISD to take into account the professional nature of the persons to whom the services are provided reflects the more general obligations under the Treaty. Restrictions on Treaty freedoms can only be justified where the burdens are proportionate.

**Conclusion**

Inappropriate regulation damages both the industry and end users of financial services. FESCO's proposals recognise the importance of ensuring that conduct of business rules appropriately distinguish between different categories of investor. Introducing an appropriate distinction for sophisticated investors across the EU will be a major step towards the realisation of the single market in financial services.