

ISDA comments on the FSA Consultation Paper 43 on Customer Classification together with a comparison of the FESCO Consultation Paper on Categorisation of Investors for the Purposes of Conduct of Business Rules and CP43

The aim of this paper is twofold:

- first, to provide comments to FSA on CP43, in particular to comment on several of the specific issues on which CP43 seeks feedback from the industry;
- second, to compare the approach taken in CP43 with that taken by the FESCO paper - which was published in final form on 15 March 2000.

In particular we wish to highlight those areas where we consider that the approach taken by the FSA in its proposals contained in CP43 is preferable to the approach taken by FESCO.

Comments on CP43

In general terms, we consider that the proposals set out in CP43 relating to customer categorisation are appropriate, and that the paper sets out a helpful discussion of the issues on this topic.

We note, however, that comments which we make on the categorisation of customers can only be provisional pending a full examination of the Conduct of Business Sourcebook proposals (currently out for consultation through CP45), combined with the Interprofessionals Code (on which we expect the FSA to consult shortly). Clearly, whether the categorisation of customers is satisfactory in practice will be heavily dependent on whether the sets of rules which are to be applicable to each of the sets of customers/counterparties are appropriate. We welcome FSA's statements in CP43 that regulatory protections designed with the interests of less experienced investors in mind should be disappplied in the case of investors with expertise and knowledge of financial markets and products. However, the question of whether the new regime as a whole produces an appropriately differentiated regime will depend heavily on the rules applicable to each category of customers/counterparties.

In relation to the specific questions raised by CP43, we have reviewed the responses given by the London Investment Banking Association on CP43 and in general wish to express our support LIBA's answers to those questions. We would specifically endorse the comments made by LIBA on the following issues: -

Question 2.1 - We believe that certain large corporates should automatically class as market counterparties. We do not agree with the approach of the FESCO paper on this issue which only foresees "large and institutional investors" falling within the top tier of professional investors if they opt up to this level.

A simple categorisation for this purpose, which would be clear-cut and easy to apply and to monitor in practice, would be all listed corporates. However, we consider that such an approach would not be ideal. For example, there are some listed companies, which have a

relatively small share capital and comparatively few net assets. It would seem inappropriate automatically to treat such entities as market counterparties. We suggest, instead, that corporates with a called up share capital or net assets above 15 million Euro, i.e. twice the size requirement imposed in relation to intermediate customers should automatically class as market counterparties. However, we accept that there should be a relatively simple mechanic available to allow such corporates to opt down to be treated as intermediate investors.

- Question 2.2 - We strongly support the proposal that all authorised persons should automatically class as market counterparties.
- Question 2.3 - We welcome the thorough description of the options available for dealing with the issue of indirect or underlying customers as set out in CP43. We strongly support the contractual solution set out in Option 2. This has the benefit of ensuring that the firm with the direct relationship with the underlying customer takes responsibility for achieving the appropriate level of customer protection, whilst avoiding the application of inappropriate levels of protection by firms in their dealings with other authorised firms. We consider that this is the appropriate result in this context. This should be clarified by the FSA in an attempt to avoid fund managers and others with regulatory duties seeking to use an approach based on Option 2 as grounds for entering into protracted negotiations every time they enter into arrangements with suppliers of financial services to seek to transfer their regulatory obligations to their suppliers. The principle should be that regulatory duties rest with those who have the direct relationship with the relevant customer.

Notwithstanding these concerns, we consider that Option 2, with its contractual solution, is preferable to Option 3. FSA acknowledges that Option 3 has the disadvantage that firms might be inclined to claim more protection than they need when using the services of other authorised firms on behalf of their customers.

We also support the position taken by CP43 in relation to investors wishing to obtain additional protections compared to the protections that are automatically available to such investors through their categorisation. These additional protections should be negotiated with the supplier and will then be a matter of contractual performance between the parties rather than an issue of compliance with conduct of business rules. It is wholly inappropriate for such additional protections, which are not considered warranted on account of the nature of the relevant customer, to be enforced by the regulator. We note with approval that this approach seems also to have been adopted in the finalised FESCO paper - whereas the FESCO consultation paper implied that such additional protections would be supported through the relevant rules.

Comparison of CP43 with FESCO Consultation Paper

Paragraph 5.4 of CP43 states that, although CP43 and the FESCO consultation paper which preceded the finalised FESCO proposals "...differ in approach, this paper and the FESCO paper are nevertheless closely aligned in that they identify similar types of 'sophisticated' investor; our

categories of market counterparty and intermediate customer are very similar to the FESCO proposals for professional investors and large/medium size investors". This section of our response to CP43 notes that, whilst there is much in common between the two papers, there are some significant differences between them. We would encourage FSA to clarify how they propose to deal with these differences. We conclude with several points where we consider that the approach of CP43 is preferable to that taken in the FESCO paper as well as issues where we consider that the FSA approach might helpfully be modified to bring it into line with useful aspects of the FESCO approach.

We have set out in the Annex to this note a narrative comparison of the main differences that we have noted between the approach to customer categorisation in the FESCO paper and CP43. This Annex helps to pinpoint differences between the two approaches.

The most significant difference between FESCO and CP43 is that CP43 proposes a clear set of graduations of treatment within the non-professional, or, in CP43 terms, non-market counterparty category of investors.

We welcome CP43's attempt to produce a more graduated approach to the rules that will apply to various types of non-professionals. Such a distinction helpfully recognises that there are strong arguments for automatically disapplying some elements of full retail investor protection when dealing with, for example, larger corporates - albeit that for at least some corporates it may be inappropriate to disapply *all* such protections and treat such entities as professional investors or market counterparties. Consequently, we consider that FSA's proposed intermediate category with its automatic qualification of many larger entities into that category is both necessary and appropriate.

We think the FESCO approach, which apparently consists of a two-tier approach of professionals and non-professionals, is overly simplistic. It seemingly proposes only two levels of rules. The "few general principles" referred to in paragraph 5 of the FESCO paper will apply in relation to professional investors and those opting to be treated as professionals. The full range of investor protection rules will apply to all others. Such an approach will inevitably result in a number of inappropriate retail style rules applying to those corporates and institutional investors who do not opt to be treated as professional investors. We consider that FESCO's category of "large and institutional" investors should automatically fall within an intermediate category, with a reduced set of rules compared to the full set of investor protection rules. Other investors, including individuals, should also be able to opt to fall within this intermediate category. The criteria proposed by CP 43 in relation to opting up from full retail protection to this intermediate category are broadly correct and appropriate and we consider that a similar approach should be adopted by FESCO.

Indeed we generally support the relatively flexible approach to opting up within the CP43 structure. CP43 proposes several objective criteria in each case. However, in relation to the steps to be taken by the relevant customer CP43 proposes an approach based on "informed consent" - requiring notification to the customer of the protections that will be lost followed by written consent of the customer. We think this is a sensible and workable approach. FESCO now proposes a similar approach for opting up large and institutional investors - in contrast to the draft FESCO paper which required the customer to take the initiative. That change to the FESCO stance is very welcome. The criteria to opt up an expert individual customer remain

relatively inflexible and onerous - see description in Annex. We support the logic behind this approach - it should not be easy for an individual investor to opt to be treated as a professional.

However, the ability within the FESCO proposal to allow sophisticated private investors to opt to be treated as professionals is welcome. CP43 does not envisage that private investors, or indeed trusts, partnerships and other non-corporates, however expert, will be able to opt to be treated as market counterparties. We consider that if the investor is sufficiently expert and experienced in the relevant market there is no reason in principle why he/she should not opt up to market counterparty status. Such investors should not just be allowed to opt to be treated as intermediate investors and then be prohibited from opting for market counterparty or professional status. This is an area that FSA should reconsider in finalising its proposals for customer categorisation.

We also support, in principle, the mechanism that FESCO proposes to allow "large and institutional investors" to opt to be classed as professionals, although, as reflected above, we think that some large corporate investors should automatically class within the top tier. In addition, we support the FESCO approach of automatically including all regulated entities as professionals. FSA should adopt a similar approach and automatically include within the category of market counterparties all entities that are regulated to carry on any form of financial services activities, including for example UCITS and pension funds, not just firms authorised to carry on investment business. Additionally, in common with the FESCO approach, a broad range of governmental organisations should automatically class as market counterparties.

We also consider that it would be appropriate to extend the categories of intermediate customer and market counterpart in CP 43 - and professional investors in the FESCO paper - to cover other members of a corporate group which includes an entity that fulfils the relevant criteria. This is important to ensure that special purpose entities set up to effect the treasury activities of the group as a whole are capable of automatically classing within the same category as other members of the group on whose behalf the relevant investment activities are being carried on.

Conclusions

In conclusion, we are broadly supportive of CP43. We also welcome in broad terms the FESCO proposals.

However, we consider that FSA should take the opportunity in the near future to explain its perception of how, if at all, its approach to customer categorisation in CP43 will be impacted by the recently finalised FESCO proposals. Specifically, we would encourage FSA to maintain its split between different categories of non-market counterparties (or, in FESCO terms, non-professionals). Whilst this additional split is not a feature of the FESCO proposals, for the reasons set out above we think it is a vital element of an appropriately differentiated customer categorisation scheme. Also, on the basis that FESCO is only dealing with the professional/non-professional split, we assume that any additional gradation within the non-professional category (i.e. among non-market counterparties in FSA terms) is a matter on which national regulators will have a free hand and not feel constrained by FESCO.

ANNEX

FESCO approach to customer categorisation

The FESCO paper proposes three categories of investor - (i) investors who are automatically considered professional, (ii) investors who opt to be treated as professional, (iii) others.

The first category consists of all authorised and regulated "financial institutions", national governments, central banks, international and supranational organisations.

The second category is then broken down into two sub-categories. The first sub-category of "large and institutional investors". This category has been expanded since the FESCO consultation to cover all "large" companies and partnerships - not just commercial and industrial corporations. "Large" is defined as an entity that meets two of the following criteria: balance sheet total of EUR 12.5 m; net turnover of EUR 25 m; and average number of employees of 250. These are the tests used to define larger enterprises for AEU accounting purposes but many exclude some financing companies and SPVs. This category also covers all institutional investors (i.e. those with a corporate purpose of investing in financial instruments - although this may not cover trusts). The second sub-category consists of other investors, including individuals acting in a private capacity, who the supplier of investment services has decided are sufficiently expert and experienced to waive full investor protection. This assessment can only be made if the investor meets two of the following criteria: transactions, at "significant size" on the relevant market at an average frequency of 10 transactions per quarter over the previous year; the investor's portfolio exceeds EUR 0.5 million; the investor has worked in a professional position in the relevant market for at least a year.

All investors who are not automatically treated as professionals must take positive steps to opt out of the application of full investor protection rules. This includes, in the case of "large and institutional investors", a notification from the service provider to the investor of the protections it will lose and a written acknowledgement of this from the investor.

In the case of the second sub-category, in addition to informing the investor of the protections that will be lost by waiver and a statement from the investor, separate to the relevant contract, to the effect that the investor is aware of the consequences of losing the protections, investors must initiate the opt-out by applying in writing to be treated as a professional.

ISDA believes that this two-tier approach to investor categorisation is too rigid. In particular we dispute the presumption implied from the FESCO approach that all large and institutional investors require the protection of conduct of business rules. As we note above, in commenting on CP43, we believe there are strong grounds for some large corporates to be classed as market counterparties. It also suggests that investment firms must comply with the full set of conduct of business rules designed for retail investors when dealing with large and institutional investors who do not opt to be treated as professionals.

CP43 approach to customer categorisation

CP43 by contrast proposes a form of three tier approach. The categories are described as market counterparties, intermediate customers and private customers. Market counterparties include national governments, central banks, international and supranational organisations. Those who are exempt persons under the Financial Services and Markets Bill are also included - however, it is not yet clear what the scope or extent this category will be.

CP43 then discusses at length whether all authorised firms should automatically class as market counterparties. The discussion comes down clearly in favour of such an approach. CP43 subsequently assesses various options for ensuring that authorised entities who enter into transactions as agent for, or otherwise with fiduciary or regulatory obligations to, an underlying customer are able to meet relevant obligations.

Intermediate customers include local and public authorities, companies or partnerships with net assets or, where appropriate, called up share capital of 7.5 million euro, trustees or trusts with net assets of 15 million euro at any time in the last two years and companies, partnerships or trusts for which the relevant firm manages assets in excess of 3 million euro. This categorisation is automatic. There is no need, in contrast to the FESCO position, for intermediate customers to opt out of full retail protection.

CP43 also proposes that corporates with a called up share capital of 15 million euro should be able to opt up from the intermediate category to classing as market counterparties.

All investors who do not automatically class as intermediate customers - private customers - may opt into this category by showing experience and expertise in the relevant markets. In assessing whether a private customer should be opted up, firms will be required to take account of issues such as the investor's knowledge and understanding of the relevant products and markets, length of relevant experience and frequency of dealings, size and nature of transactions and financial standing.

Opting up under the CP43 proposals, as under FESCO, will require the written consent of the investor following written notification from the financial services supplier of the protections the investor will lose.