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## **Proposed Communication on the Investment Services Directive**

I am writing on behalf of the Futures and Options Association (FOA), the International Primary Market Association (IPMA), the International Swaps and Derivatives Association (ISDA), and the International Securities Market Association (ISMA). We collectively represent the participants in the European capital markets. We understand that the Commission is considering issuing a Communication on the implementation of Article 11 of the Investment Services Directive (ISD) in the light of the recent paper, "Implementation of Article 11 of the ISD: Categorisation of Investors for the Purposes of Conduct of Business Rules", issued by the Forum of European Securities Commissions (FESCO).

You will not be surprised that we regard the treatment of interprofessional business under the ISD as a matter of great importance to our respective members. We therefore welcome the priority given to the question by FESCO and the EU Action Plan. The current situation where Member States apply different definitions of professional investor and apply different conduct of business rules imposes significant costs and acts as a barrier to cross-border business. Well managed firms spend a lot of unnecessary effort on keeping upto date with changes in rules in this area, on verifying - often on a transaction by transaction basis - what different requirements apply in practice and on ensuring compliance across the firm with them. We see little economic or regulatory sense in the status quo.

We would therefore argue that a European regulatory regime based on the following key principles would greatly facilitate the development of the more efficient, liquid European capital markets that our political leaders have repeatedly called for in recent European Councils:

- Interprofessional business should be subject to a lighter regime than retail business
- All regulation of interprofessional business should be country of origin based, underpinned by the evolution of pan European regulatory standards.

We remain concerned, however, that there is still little prospect of changes to national rules that currently unnecessarily restrict cross border activity. Both FESCO and the members of FESCO with whom we have discussed the issue in recent months seem to take the line that a genuine single market has to await the full harmonisation of national rules applied under the ISD. We reject this proposition on both legal and practical grounds. On the former, we would urge the Commission to reject it too as contrary to the principles of the Treaty and of the single market. On the latter, whilst we are supportive of greater approximation of regulation across the EU, we suspect that introducing harmonised rules is a very long-term project. We would therefore argue that the time is now right, following the recent agreement in FESCO, for the Commission to take a more forceful position in relation to enforcing the Treaty and the ISD. There is now no reason why inter-professional - at least as defined by FESCO - cross border business should be restricted by disproportionate and duplicative national conduct of business rules which are inappropriate in the context of the sophisticated, international wholesale markets in which our members operate.

We therefore attach a short paper outlining some of the issues we believe the Commission should be addressing in its Communication. We have drawn on the paper dated 2 December 1999 submitted jointly to FESCO by ISDA, IPMA and ISMA on the earlier, consultation draft of the FESCO paper. We also refer to the FOA response of 3 December 1999. Finally, we draw too on the paper dated 2 December 1999 which ISDA submitted to your officials for consideration by the ISD Forum group.

The paper recommends that the Communication make the following main points:

- Member states are obliged by the Treaty and by the ISD to apply proportionate rules to passported business.
- Member states should ensure that the full range of their rules, including on solicitation and advertising, differentiate between sophisticated and retail investors.
- In the case of sophisticated investors, little more than general principles are appropriate and these can be applied solely on a country of origin basis.
- The FESCO categorisation of professional investors is helpful, but service providers should also be able to treat other sophisticated counterparties on a professional basis.
- Where sophisticated counterparties, in particular large corporates and institutional investors, elect not to be treated as full professional counterparts, service providers should only be required to provide an intermediate level of investor protection rather than the full range of retail investor protections.
- Member states should ensure transparency of the rules applicable to cross border business.
- The Commission will take action against member states disregarding their obligations.

We hope you find this paper helpful. We would be pleased to discuss it further with you or your officials if that would also be useful. We are moreover content for you to pass this letter on to any relevant working groups and indeed to make this letter public. We may for our part post it to our websites.

Yours sincerely

Nick Collier  
Senior Director of European Policy  
Head of European Office

## **FOA, IPMA, ISDA and ISMA Comments on a Possible Communication on the Investment Services Directive Article 11 of the Investment Services Directive (ISD)**

Article 11 of the ISD requires the Member States to draw up conduct of business rules for investment firms. However, it also states that those rules "must be applied in such a way as to take account of the professional nature of the person for whom the service is provided". Furthermore, the 32<sup>nd</sup> ISD recital states that "it is therefore appropriate to take account of the different requirements for protection of various categories of investors and of their levels of professional expertise". As the Forum of European Securities Commissions (FESCO) recognises, in its recent paper on Article 11, the ISD therefore requires Member States to ensure that conduct of business rules "take account of the client's knowledge and experience in the area of investment services and instruments".

In this respect, Article 11 reflects the requirements of the Treaty. Under the Treaty, restrictions on the freedom to provide services can only be sustained where they are adopted in the interests of the general good. As the Commission has already confirmed in its earlier Communication on the Second Banking Coordination Directive (97/C 209/04) this means, among other things, that restrictions must be proportionate to the objective intended to be pursued. As was stated in that Communication, in relation to rules, such as conduct of business rules, designed to protect the recipient of the service, this means that "it is essential, in checking whether the proportionality test is satisfied, to question the actual need to protect the recipient [of the service]". The Commission then concluded that Member States should:

"in imposing their general-good rules, make a distinction according to whether or not services are supplied to circumspect recipients. In other words, in order to respect the principal of proportionality, they should take into account the degree of vulnerability of the persons they are setting out to protect."

In some cases, member states do not at present make this distinction and are therefore likely to be in breach of their Treaty obligations. One obstacle to member states agreeing to differentiate the expertise of an investor in a cross border context has apparently been the lack of a common understanding of what kinds of investors should be regarded as sophisticated enough to dispense with the protection offered by these rules. A common agreement by regulators on the definition of a professional investor would be a useful step in the right direction.

- *The Communication should remind member states of their obligation under the Treaty and under Article 11 to apply the principle of proportionality and to differentiate between professional and non-professional investors.*

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

The success of any conduct of business regime rests on the content of the rules that apply as well as the categorisation of investors. In this respect we welcome the agreement by FESCO that only "a few general principles, and possibly a limited number of standards for specific types of services and transactions, as well as any additional rules agreed by the parties concerned, should apply to inter-professional relationships" (paragraph 5 of the FESCO paper).

However, there is clearly scope, under this formulation, for Member States to continue to impose inappropriate rules on inter-professional business. As already noted, the Commission has already made clear in its earlier communication on the 2BCD that transactions "between professionals in the financial sector ... should not be the subject of particular general-good rules ... The proportionality test would be especially difficult to satisfy in such cases".

In addition, we also think that it is essential to ensure that appropriate rules apply to business with “large and institutional investors”, to use the FESCO terminology, who do not opt to be treated as “professional investors.” We would like to see clarification that full investor protection rules are inappropriate for all sophisticated investors, a term that includes the FESCO definition of “professional investors” as well as such “large and institutional investors”. The essence of these categories is that the investors are to be taken, in the Commission’s words, to be “in a position to recognise the risks they are incurring and to commit themselves in full knowledge of the facts”.

- *The Communication should reiterate the requirement on Member States to ensure that in practice all rules applicable to business with sophisticated investors are proportionate to the objectives sought to be achieved. In particular, it should emphasise that it would be inappropriate to impose on investment firms obligations to provide detailed information on the risks of proposed transactions to these categories of investors or to take responsibility for ensuring that proposed transactions are suitable for those investors.*

### **Territorial application**

Common terminology and agreement on broad principles for wholesale business do not resolve the problems of different member states’ overlapping and conflicting rules affecting cross-border business. As we have argued before (see, for example, the ISDA paper to the ISD Forum Group from last December) 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. . We would mention two main points here.

First, the ISD only allows the host state to impose its rules on an investment firm conducting cross-border business where the "services are provided in" the host state (Article 11(3) of the ISD). As the Commission made clear in its earlier Communication on the Banking Directive, services are not provided "in" a host state merely because the customer or counterparty is located there or because the firm has initiated a relationship with that customer or counterparty (or solicited business from them). Services are only regarded as provided "in" a host state where the characteristic performance of those services takes place in that Member State. It makes little sense for example to argue that the characteristic performance of an interest rate swap contract or of an exchange traded derivative contract takes place in the Member State of the firm's counterparty.

Second, even where the services can clearly be said to be provided "in" the host state, that state still may only impose its own rules where this is justified in the interests of the general good. The Commission has already emphasised the difficulty of host states establishing that restrictions are proportional in the context of inter-professional business. In addition, and even more importantly, the Commission's earlier Communication on the Banking Directive emphasised that the assessment of whether a host state restriction is proportional may differ depending on whether the firm is acting in the host state through a branch or under the freedom to provide services. That Communication emphasised that a "lightweight" legal framework should apply to suppliers operating cross-border. It also recognised that whilst a host state may have a special concern in applying its own rules where a supplier is dealing cross border with retail consumers, the position is quite different where the supplier is dealing with other categories of investor. The ISD cannot empower Member States to impose their own rules in circumstances where this would not, in any event, be permitted by the Treaty.

We would also add that we would welcome the emergence of pan European conduct of business standards for wholesale markets. This could we believe reinforce the principle of country of origin regulation and we stand ready to contribute to this process.

- *The Communication should emphasise that, even in the absence of amendments to the ISD, the Directive and the Treaty impose significant limits on the extent to which host Member States can impose their rules on cross-border business, especially where that business is conducted with professional and other sophisticated investors. It should argue that in these circumstances the principle of mutual recognition of country of origin regulation should apply.*

### **Structure of FESCO's proposals**

Given the arguments above, we would conclude that prior agreement by FESCO on the categorisation of investors, and indeed on what kinds of regulatory regime to apply to them, is not a precondition for Commission action to enforce the Treaty and the ISD. We would, however, agree that agreement on common standards by FESCO is generally to be welcomed and should facilitate the emergence of a more integrated capital market in the EU. We therefore welcome FESCO's attempt to reach agreement on a common categorisation of investors for the purposes of the application of conduct of business rules. Indeed, as argued above, we believe that the ISD and the Treaty require Member States to ensure that rules designed for the protection of investors distinguish between different categories of investors.

We also believe that the FESCO paper should facilitate action by the Commission to clarify the requirements of the ISD in a Communication and subsequently to enforce them. We do, however, have some difficulties with the FESCO paper, which need to be taken into account in preparing a Communication. Our points were made in more detail in our original responses to FESCO. In particular, we continue to believe that FESCO's proposal to establish two distinct categories of investor is too rigid. In our view, it suffers from two main failings.

First, FESCO creates a presumption that sophisticated ("large and institutional") investors not counted as "professional" require the full protection of conduct of business rules. Under FESCO's proposal, an investment firm will only be able to treat "large and institutional investors" (paragraphs 12 and 13 of the FESCO paper) as "professional investors" where the investors have agreed to waive the protection of conduct of business rules i.e. where the investor has opted to be treated as a professional (paragraph 17 of the FESCO paper). However, the presumption should surely be that a sophisticated investor such as the treasury department of a large corporation dealing regularly in interest rate swaps should be treated as a professional unless they agree otherwise with the service provider. Under FESCO's proposal, the presumption is reversed.

Second, FESCO suggests that investment firms must comply with the full set of conduct of business rules designed for retail investors when dealing with sophisticated investors who do not opt to be treated as professionals. This is misguided. It cannot be right, for example, to require an investment firm to comply with all the conduct of business rules applicable to dealings with retail investors when dealing with a sophisticated treasury department of a large corporation merely because that corporation has not opted to waive those rules. In other words, there is in practice a third, intermediate category of sophisticated

counterparty falling between professional investors and retail investors who also require a lower level of protection than retail investors. We therefore take issue with FESCO's statement that the conduct of business regime for "professional" investors is "an exception to the application of the standard conduct of business rules which aim to ensure adequate protection for less sophisticated investors" (paragraph 7 of the FESCO paper).

We believe that the concept of a three tier system, that explicitly or implicitly distinguishes between the rules applicable to dealings with professional investors, the intermediate category and retail investors, would be more politically acceptable to those States who are nervous about a simple 'all or nothing' option. It is also consistent with the Commission's statements in its Communication on the Second Banking Co-ordination Directive. In that Communication, the Commission indicated that Member States should recognise that there is a category of "circumspect investors" who "are of a nature or size to recognise the risks they are incurring and to commit themselves in full knowledge of the facts". That Communication also suggested that there should be special treatment of "professionals in the financial sector" - transactions between professionals of this kind should not be subject to particular general-good rules. Furthermore, it did not suggest that membership of the category of "circumspect investors" should depend on whether or not the particular investor had opted for that treatment. In fact, a number of Member States (such as Italy, the Netherlands and the UK) already allow a firm to treat large or listed companies as professionals or as having some other special status for conduct of business rules purposes without requiring those companies to "opt in" (or allowing them to "opt out") of that categorisation. Indeed, it would be inconsistent with the basic thrust of the Commission's remarks in that Communication if the question of whether or not an investor was to be treated as "circumspect" depended on the investor's own initiative to waive the protection of general-good rules. That said, investors should be given the opportunity to object to a firm's categorisation of them.

In addition, it should be noted that it would be illogical to require firms to treat sophisticated individual investors (and smaller companies) as either professional or retail rather than in an intermediate category. This would result in the imposition of unjustifiable, disproportionately burdensome requirements. Accordingly, the Commission Communication should emphasise that firms should be allowed to treat sophisticated individual investors (and smaller companies) as part of the intermediate category of investors where an assessment of their expertise indicates that this is appropriate. As a general principle, it is surely right to encourage investors to take responsibility for their investment decisions. Imposing investor protection requirements designed to protect inexpert investors, such as those on suitability and ongoing information provision, on expert investors makes little economic sense. It increases the risk of moral hazard and creates economic inefficiencies.

Further more detailed comments on the FESCO categorisation are listed at the end of this paper.

Our main conclusions are that the Communication should make clear that:

- Member States should allow investment firms to presume that sophisticated investors (at least some "large and institutional investors") are "professional investors" to whom the inter-professional regime applies; and
- Member States should not require investment firms to comply with the full set of retail conduct of business rules when dealing with large and institutional investors merely because the investor has failed to opt to waive the protection of those rules. Firms should also be able to apply an intermediate regime

to sophisticated investors who do not meet the requirements of a “large” or “institutional” investor or who bilaterally agree that they should be treated as an intermediate rather than professional counterparty.

## **ISD Implementation and Enforcement**

The ISD was adopted in 1993 and required Member States to implement its requirements by 1 January 1996. However, more than four years after the implementation date, some Member States are still considering the exact method by which they should implement the ISD's requirements. Indeed, the FESCO paper suggests that little progress will be made actually implementing its proposals until FESCO members have agreed on the approximation or harmonisation of the conduct of business rules themselves.

This is disappointing. Firms conducting cross-border business within the Community continue to face inappropriate, overlapping and conflicting requirements, even when they are conducting business with sophisticated investors. The proposed Communication should state that the Commission will take immediate enforcement action if Member States now fail fully to reflect the requirements of the ISD in their conduct of business rules, in particular by adequately differentiating between the different categories of investor and the treatment of cross-border business.

In addition, the Communication should emphasise that implementation should not be limited to a narrow sub-set of conduct of business rules covered by Article 11 of the ISD. Implementation should also cover the full range of national rules designed for the protection of investors, such as rules restricting advertising or the solicitation of investors. These restrictions can also only be justified where adopted in the interests of the general good (see e.g. Article 13 ISD in relation to advertising and marketing restrictions).

Implementation should also be transparent. The Commission should encourage Member States to make plain how any new rules on inter-professional business inter-relate to existing rules. Uncertainty as to which rules apply is itself a significant barrier to cross-border business. Indeed, we would go further and argue that the sweeping application of often inappropriate conduct of business rules to wholesale business combined with a degree of opacity as to precisely which rules do in fact apply serves as a significant barrier to new entrants in these markets. Opacity of regulation, for example as applied to transitional or grandfathering arrangements, undermines the efficacy of investor protection and increases the likelihood of inadvertent rule breaches.

The Communication should

- *Commit the Commission to taking action against member states acting contrary to their Treaty obligations and make it clear that the single market is not dependent on full harmonisation of rules.*

## **Public Consultation**

We believe that broad, public consultation is an essential part of the regulatory process. 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 the 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. It is also particularly important in the context of regulation that impinges on cross-border business for consultation to solicit the broadest possible input and not just be limited to selected national market participants or trade associations.

The Communication should

- *Emphasise that broad, public consultation on the national proposals for implementation is one of the best ways of ensuring that regulation remains proportionate to the objectives intended to be achieved and thus consistent with Treaty obligations.*

## **Conclusion**

Inappropriate regulation damages both the suppliers and end users of financial services and carries real economic costs. The ISD offers the scope for the EU to develop a more integrated capital market but progress has been hampered by poor implementation, notably of the requirement on Member States to differentiate between sophisticated and retail investors and to apply a proportionate regime to interprofessional activity. Although we have significant concerns regarding the FESCO proposals, they represent an opportunity to move to a more integrated, efficient and competitive wholesale market in the EU. A Commission Communication along the lines outlined in this letter would help to achieve that goal. We would be happy to participate in further dialogue and consultation on the precise contents of a Communication.

Annexe

### **Detailed issues on FESCO's proposals**

The FESCO paper fails to take account of the position of subsidiaries within a group. For example, it would clearly be inappropriate to treat a specialised financing subsidiary of a major multinational group of companies as a non-professional merely because the subsidiary does not itself meet the size tests on its own.

The proposed Communication should emphasise that it would be disproportionate if Member States' rules did not take into account the reality of the position of groups of companies. For example, the category of "large and institutional investors" should be extended to include subsidiaries of entities authorised or regulated to operate in the financial sector and other large or institutional investors (e.g. subsidiaries of listed issuers). In addition, firms should be entitled to treat entities as meeting the size tests where they are members of a group of companies meeting those size tests on a consolidated basis.

In this respect, it is notable that FESCO's proposed size tests (based on Article 27 of Directive 78/660/EEC, as amended - see paragraph 13 of the FESCO paper) are more restrictive than those proposed in the Commission's earlier Communication on the 2BCD (based on Article 11 of Directive 78/660/EEC, as amended). This suggests that the lower threshold size tests should be taken as the entry point to the third, intermediate category of sophisticated investors referred to in our paper.

Also, it is inappropriate to require firms to discriminate between entities whose securities are listed on EU, as opposed to other, regulated markets (see paragraph 12(f) of the FESCO paper). The proposed Communication should emphasise the importance of using objective, justifiable standards where differentiating between investors based on the listing of their securities.

The minimum criteria specified in FESCO's paper for the categorisation of individuals and small companies as professional (paragraph 16 of the FESCO paper) are unduly restrictive, particularly now that investors must meet two of the minimum criteria. However, the practical burden that this would entail would be reduced if it were clearly recognised that Member States are required to allow individuals to be categorised in the intermediate class of sophisticated investor if they are sufficiently expert. In this regard, it would be inappropriate to insist that the investor meets these minimum criteria since this intermediate class may still benefit from the protection of some, albeit more limited conduct of business rules.