



Date: February, 2001  
Ref.: Fesco/00-124b

**STANDARDS AND RULES FOR HARMONIZING  
CORE CONDUCT OF BUSINESS RULES  
FOR INVESTOR PROTECTION**

**Consultative paper**



## **Cover Note**

During its last meeting in Vienna, held on the 14th and 15th December 2000, FESCO members agreed to publish for consultation the paper on the proposal for the harmonisation of conduct business rules for investor protection (ref. FESCO/00-124b).

The differences between the conduct of business regimes within the European Economic Area (EEA) are unanimously regarded as a major obstacle to the effective cross-border provision of investment services. Furthermore, the harmonisation of conduct of business rules is considered by the Financial Services Action Plan and by a recent Communication from the European Commission on upgrading the Investment Services Directive (ISD), as a priority for the achievement of an integrated securities market for investors, intermediaries and issuers alike. FESCO members undertook to work in the area of investor protection and particularly on the harmonisation of article 11 of the ISD.

A FESCO expert group, chaired by Jacob Kaptein, Commissioner of the Dutch STE, has worked intensively in this area and, from a comparison of different regimes throughout FESCO members, has developed the current proposals.

- FESCO has adopted in March 2000 a paper on “Implementation of article 11 of the ISD: Categorisation of investors for the purpose of conduct of business rules” (00-FESCO-A), following an intensive periode of consultation. It provides criteria and procedures to implement an appropriate differentiation between categories of investors; among others, these criteria were endorsed by the European Commission in its recent Communication on the interpretation of article 11 of the ISD, which was widely welcomed by FESCO members;
- and FESCO has agreed to start a consultation on the “Standards and rules for harmonising core conduct of business rules for investor protection” (ref. FESCO/00-124b). This document is the outcome of intense discussions within the expert group, with the aim of reaching a balanced approach ensuring a high degree of investor protection at a reasonable cost. FESCO believes that a balance was reached on the regime applicable to retail investors, while the application of conduct of business rules to professionals may deserve further attention. In any case, the paper has now reached a stage of development where intensive period of consultation would provide a valuable contribution to finalising this paper.

These documents are intended to be complementary and part of the same exercise, aimed at providing a harmonised framework for the provision of investment services throughout the EEA.

Intermediaries have first to categorise their clients on the basis of the criteria laid down in the FESCO document; then, either the retail or the professional regime applies.

The scope of the document covers article 11 of the ISD. On some issues, notably the information content of marketing activities, FESCO members choose to cover more in the interest of investor protection. In particular this includes:

- the provision of services to non-professional investors, as well as the services rendered to professional investors;

- principles and rules on the provision of the investment services, as defined in Section A of the Annex to the ISD, but, where appropriate, it also covers non-core services. Provisions of general application are separated from those concerning specific aspects of the relationship between the intermediaries and their customers. Additional principles and rules have been drawn up for specific services (e.g. discretionary portfolio management, execution-only business) or financial instruments (e.g. derivatives). The document is intended to be independent of business models and technology: Accordingly, it covers both services provided in traditional ways (face-to-face), as well as those provided at distance (telephone, on-line).

On the content of the document, FESCO obviously welcomes comments on all parts, but there are some areas on which FESCO is particularly interested in feedback:

- *Execution only* (principles 83 and 84). FESCO recognizes that fast growing numbers of investors in Europe do not wish their intermediaries to judge whether each transaction is suitable for them or not. With the increased use of on-line services this phenomenon is growing quickly. In the consultation document, FESCO proposes to facilitate this type of business providing that the client gets adequate information to make an informed judgement, all other protection remains in place and the execution only broker does not make any personal recommendation to the customer. In light of the existing EU legislation, principle 83 requires any investment firm to seek from each client information regarding their financial situations, investment experience and objectives as regards the services requested.
- *The professional regime* (chapter IV). The document develops a proposal to be applicable to inter-professional relations where a minimum regime applies. Within the minimum regime they can opt for extra-protection when they ask their intermediary to act as their agent. Alternatively they can always “opt out” and be entitled to the same full protection that applies to the retail investor. FESCO members are particularly keen to know how the interprofessional regime should be tailored in order to be consistent with the market practices.

Some other aspects of the relations between intermediaries and their customers are not yet included in the document. Comments are also welcomed on these items. FESCO has identified the following issues:

- *cold calling* : traditions vary widely in Europe, from total bans to permission under strict rules. Furthermore, the approval of the EU directive on distance marketing of financial services is pending. FESCO stands at cross roads: should FESCO strive for a total ban or propose to allow it under strict conditions (thereby inviting cold calling back in those jurisdictions where it is band today)? Comments are sought with regard to problems encountered with various regulations of cold calling throughout the EEA ;
- some aspects of the internal organisation of the investment firms (such as segregation of assets and functions), although relevant for the investor protection, are considered as being part of prudential regulation and, therefore, outside the scope of the document;
- the contents of this document are without prejudice to more specific work in other areas, for example primary markets and market abuse. The content of the specific papers always goes first ;
- a regime for the so called “grey market” .



## Consultation

FESCO intends to develop the consultation process along both national and European lines. Each of the FESCO member will organise local consultations according to their local practices. Experts from the FESCO Expert Group on Investor Protection are available to participate in these discussions. It is FESCO's intention to organise, during the consultative period, open sessions in liaison with the appropriate industry and investors associations and their members. FESCO will approach a number of European Associations to organise pan-European consultations. Furthermore, the consultation document is available on FESCO's web site ([www.europefesco.org](http://www.europefesco.org)) with the invitation to submit contributions directly to FESCO. The document is open to public consultation for a period of 3 months. Comments may be forwarded to the Secretary General of FESCO (e-mail: [fdemarigny@europefesco.org](mailto:fdemarigny@europefesco.org), or 17 place de la Bourse, 75082 PARIS CEDEX 02, FRANCE, tel.: +33.1.53.45.63.61, fax: +33.1.53.45.63.60).



# **FESCO PROPOSAL FOR HARMONISATION OF CORE CONDUCT OF BUSINESS RULES FOR INVESTOR PROTECTION**

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## **I. INTRODUCTION**

### **The need to develop Principles and Rules for investor protection by harmonisation of core conduct of business requirements.**

1. The development of the single market in financial services warrants a common approach from the members of the Forum of European Securities Commissions (FESCO) <sup>(1)</sup> to those principles and practices governing the provision of investment services which the ISD frames at a high level of generality under the heading "rules of conduct". According to article 11 of the ISD, rules of conduct must implement at least the principles set out in this article and must be applied in such a way as to take into account the professional nature of the person to whom the service is provided.
2. The ISD establishes some basic conduct of business requirements for EU investment firms. FESCO members believe, however, that the present diversity of conduct of business regimes may hinder not only the freedom which investment firms have to provide services throughout Europe but also the provision of an adequate level of protection to European investors. It is therefore necessary to undertake a process of convergence in this field, both to ensure a level playing field for investment firms and to foster public confidence in the operation of the single market in financial services. FESCO members are aware that in this respect a green paper on the ISD has been published as part of the process to update the ISD.
3. The benefit of this work is to provide investors, investment services providers and EEA regulators, with a clear and concise statement of the Principles and Rules on conduct of business that FESCO members expect investment firms to meet. .

### **The Principles and Rules**

4. The main body of the paper is composed of several chapters. Each chapter contains Principles followed by more or less detailed Rules. The Principles are intended to be the key parameters for a harmonised conduct of business regime. The Rules implement the Principles, clarifying their scope and practical meaning. Both Principles and Rules are intended to be mandatory.
5. Within their sphere of application the Principles and Rules have three main aims:
  - a) ensure that investors throughout the EEA enjoy an equivalent degree of protection, irrespective of the means used by investment firms to provide investment services;
  - b) improve the flow of financial services within the EEA by reducing impediments to competition and competitive distortions between investment firms;
  - c) foster mutual understanding and co-operation between the competent authorities as regards the interpretation and implementation of conduct of business rules.

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<sup>(1)</sup> The Forum of European Securities Commissions (FESCO) assembles the following 17 Statutory Securities Commissions of the European Economic Area (EEA): Bundes-Wertpapieraufsicht (Austria); Commission bancaire et financière/Commissie voor het Bank- en Financiewezen/Kommissie für das Bank- und Finanzwesen (Belgium); Finanstilsynet (Denmark); Rahoitustarkastus (Finland); Commission des opérations de bourse (France); Bundesaufsichtsamt für den Wertpapierhandel (Germany); ΕΠΙΤΡΟΠΗ ΚΕΦΑΛΑΙΑΓΟΡΑΣ / Capital Market Commission (Greece); Financial Supervisory Authority (Iceland); Central Bank of Ireland; Commissione Nazionale per le Società e la Borsa (Italy); Commission de surveillance du secteur financier (Luxembourg); Stichting Toezicht Effectenverkeer (Netherlands); Kredittilsynet (Norway); Comissão do Mercado de Valores Mobiliários (Portugal); Comisión Nacional del Mercado de Valores (Spain); Finansinspektionen (Sweden); Financial Services Authority (United Kingdom). The European Commission attends FESCO meetings as an observer. The Chairman of the IOSCO European Regional Committee is also invited as an observer. FESCO is chaired by Georg Wittich, Chairman of the Bundesaufsichtsamt für den Wertpapierhandel (Germany). The Conseil des marchés financiers (France) participates in meetings of the expert group on investor protection. The Secretariat of FESCO is located 17, Place de la Bourse 75082 PARIS CEDEX 02 - FRANCE - Tel: 33.1.53.45.63.51 - Fax: 33.1.53.45.63.50

6. This paper builds on the earlier FESCO paper entitled "Implementation of article 11 of the ISD: categorisation of investors for the purpose of conduct of business rules" and accordingly differentiates the rules that apply to retail and professional customers. First, an investment firm has to assess whether a customer is a professional according to the criteria of last mentioned paper. After having done so, it knows whether it has to apply the Principles and Rules for non-professional customers or those for professional customers.

### **Scope and structure of the paper**

7. With regard to the scope of the paper it is emphasised that the paper is without prejudice to the provisions of any of the Directives of the European Union or national laws and regulations implementing such Directives, in particular as regards the directives 80/390/EEC (listing particulars), 89/298/EEC (public offer), 85/611/EEC (UCITS) 93/13 EC (on unfair terms in consumer contracts) and 84/450/EEC (on misleading advertising)<sup>(2)</sup>. Furthermore, this paper is without prejudice to national laws and regulations concerning public offering of financial products, in particular of non-harmonized financial products.
8. This paper sets out definitions in chapter II. The Principles and Rules that the members of FESCO consider to be necessary (as far as subjects dealt with in this paper concerned) to ensure appropriate investor protection are set out in chapter III for retail and in chapter IV for professionals. This last chapter contains a selection of these Principles and Rules of chapter III, which should also apply to business relationships between professionals. Chapter III and chapter IV develop the following sections that apply to an investment firm's relationships with customers and professionals:
  1. Principles and Rules of general application;
  2. Information to be provided to customers;
  3. "Know your customer" and suitability (information to be sought from customers);
  4. Customer agreements;
  5. Dealing requirements (including the "best execution" principle);
  6. Discretionary portfolio management ;

### **Implementation**

9. FESCO members will seek to implement the Principles and Rules set out in this paper in their regulatory objectives and, when possible, in their respective rules. If a FESCO member does not have the authority to implement a certain Principle or Rule, it will commend the Principle or Rule to its government and to the responsible regulatory authority.

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<sup>(2)</sup> FESCO members are aware that the European Council is negotiating a directive on distance marketing on the consumer financial services which will be applicable also to services regulated under the ISD (93/22/EEC). The policy of the Commission is to achieve agreement on a list of generic information that should be given to the consumer prior to the conclusion of the contract. Therefore it can result in an amendment/derogation to what is provided for in the FESCO paper. The list of generic information and the interaction with specific information requirement provided for by community sectoral directives is currently under discussion in the Council between the Commission and Council members.  
FESCO members are also aware that the proposal on distance marketing deals with issues such as cold calling, use of voice telephony communications, right of withdrawal, redress and burden of proof.  
FESCO members are finally also aware of the fact that directive 2000/31/EC (e-commerce) provides for certain rules on information to be provided by the service provider and on unsolicited communication. The commission is drafting a communication on e-commerce and financial services.

Objectives of the paper

10. The broad objectives which FESCO has focused on when constituting the Principles and Rules are the following:
  1. Ensuring that information provided to customers enables them, take their investment decisions on an informed basis, promptly react against actual or potential losses, and reflect on the consistency between their investment objectives and strategies and their actual portfolios.
  2. Ensuring that information from a customer:
    - determines the scope of the information to be provided to such a customer so that he may properly take his investment decisions.
    - includes the customer's trading restrictions or other comparable circumstances which may affect the provision of services.
    - enables investment firms to ensure that customer's dealings and or advice are suitable.
  3. Ensuring that a written contract setting out the rights and obligations of the parties has been concluded between the investment firm and its customers prior to the provision of investment services.
  4. Ensuring that investment firms:
    - operate independently, impartially and in the best interest of investors when handling customer orders;
    - obtain the best possible result with reference to the time, size and nature of customer orders, taking into account the state of the relevant market
  5. Ensuring that with regard to portfolio management:
    - The customer understands the nature and particularities of this service.
    - The customer agreement takes into consideration the particular characteristics of this investment service and includes specific instructions of the customer.
    - The portfolio is managed in accordance with the instructions given by the customer.
  6. Ensuring that investment firms manage conflicts of interest fairly and provide appropriate disclosure to their customers in this respect.
  7. Ensuring that investment firms establish a code a conduct for management and staff, and policies and procedures designed to ensure compliance with such a code and conduct of business rules generally”.
  8. The overriding principle finally is that an investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of its customers.



## II. DEFINITIONS

- **Cash financial instrument:** financial instruments other than derivatives.
- **Competent authority:** a Securities Commission within the European Economic Area, responsible for conduct of business rules. Where appropriate in the context, the term may refer to the authority that authorises or registers an investment firm, or to third-country regulatory bodies.
- **Compound product:** a financial product, which consists of a combination of financial instruments, e.g. a stock-lease product combining a loan, a cash financial instrument and an option.
- **Derivatives:** a financial instrument whose value changes with the movements in the value or the level of an underlying asset, index, interest or currency rate or other parameter (e.g. futures, options, swaps, warrants, contracts for differences).
- **Direct offer marketing:** a marketing communication, which contains an offer to enter into an investment agreement (or an invitation to make such an offer) and which gives the respondent the opportunity to accept the offer directly and immediately, e.g. where an advertisement in a newspaper contains a coupon to be mailed back to the investment firm<sup>(3)</sup>.
- **European Economic Area:** the Member States of the European Union, Norway, Iceland and Liechtenstein.
- **Financial instruments:** any of the instruments mentioned in section B of the annex to the ISD. Where appropriate in the context, the term may cover other types of instruments, in particular commodities and commodity derivatives.
- **ISD:** Directive 93/22 on investment services in the securities field.
- **Investment firm:** Firms as defined in point 2 and 3 of Article 1 of Directive 93/22/EEC.
- **Investment service:** any of the services mentioned in section A of the annex to the ISD. Where appropriate in the context, the term may cover non-core services mentioned in section C of the annex to the ISD, in particular safekeeping and administration of securities and investment advice.
- **Legal entity:** a person in particular a customer of an investment firm, other than a natural person. The term is meant to cover partnerships and trusts.
- **Leverage:** the ratio of the market exposure of a portfolio to the exposure as if the portfolio would be fully invested in the underlying cash financial instruments.
- **Leveraged portfolio:** a portfolio with a leverage greater than one.
- **Leveraged transactions:** transactions in derivatives, short sales of securities and purchases of any instruments using borrowed funds.

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<sup>(3)</sup> In some countries a direct offer marketing of services or products may be considered as provision of investment services or solicitation to the public, and an authorization could be required

- **Marketing communication:** Any form of information issued by or on behalf of an investment firm to the public, that advertises, makes a recommendation or acts as a solicitation regarding investment services and/or financial instruments. So-called “image” advertisements, however, which are not used to recommend any particular service or instrument or to solicit business, but which are designed simply to make the public aware of a investment firm’s existence are not deemed to be marketing communications.

The wording “to the public” refers to the fact that a marketing communication is designed for and addressed to a number of people and not to one specific client or potential client. This does not preclude the investment firm, however, from addressing marketing communications to its existing client base.

There is no restriction on the media of communication, which is used for the marketing. The definition therefore applies to marketing information communicated by way of printed advertising, e-mails, the Internet and electronic media such as digital and other forms of interactive television or any combination of these means of communication. Activities and communications potentially covered by the definition of marketing communication include, for example: (a) the distribution of written product brochures; (b) general advertising; (c) the distribution of mailshots (whether by post, facsimile, e-mail or other media); (d) telemarketing activities, including oral communications such as from call centres; (e) presentations to groups of private customers; (f) tip-sheets; and (g) other publications, which may contain non personal recommendations as to the acquisition, retention or disposal of financial instruments of any description.

- **Professional:** a professional customer or a (professional) counterparty.
- **Regulated markets:** markets which are notified to the European Commission on the basis of article 16 of the ISD. Where appropriate in the context, the term may cover other organised markets operating on a regular basis and open to the public provided that they may be considered as offering a similar level of investor protection.
- **Soft-commission:** Any agreement, whether oral or written, under which an investment firm receives goods or services in return for business done with or through another person, whether on a prepaid, continuous or retrospective basis.
- **Uncovered short positions:** all short positions of which the market exposure is fully hedged, e.g. short sale of securities and writing call options on instruments without the underlying assets available in the portfolio.
- **Written agreement:** a contract in writing or in a similar unalterable electronic form having equivalent evidentiary status. Information to be given “in writing” is to be understood in the same way.

### **III. CORE CONDUCT OF BUSINESS RULES FOR INVESTOR PROTECTION**

#### **1. PRINCIPLES AND RULES OF GENERAL APPLICATION**

##### **1.1 GENERAL**

- **PRINCIPLES**

- 1. An investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of its customers.***
- 2. An investment firm that delegates or outsources any services to other providers, shall ensure that the choice of the latter is based on their ability to perform the services professionally and in the best interests of its customers.***
- 3. An investment firm must refrain from doing business with any other firm that has not obtained the required authorisation.***

##### **1.2. CONFLICTS OF INTEREST**

- **PRINCIPLE**

- 4. An investment firm must take all reasonable steps to ensure that conflicts of interest between itself and its customers and between one customer and another are managed in such a way that the interests of customers are not adversely affected.***

- **RULES**

- 5. An investment firm may not undertake business with or on behalf of a customer where it has directly or indirectly a conflicting interest, including any such interest arising from intra-group dealings, the joint provision of more than one service or other business dealings of the investment firm or any affiliated entity, unless it has acted in accordance with an internal independence policy designed to prevent conflicts of interest such as Chinese Walls and it has previously disclosed to the customer the nature and extent of its interest in the business and the customer has expressly agreed to engage in such business with the investment firm.***
- 6. The disclosure to the customer and the agreement by the customer must be given either in writing or by telephone and recorded by the investment firm.***

##### **1.3 INDUCEMENTS**

- **PRINCIPLE**

- 7. Where an investment firm receives or gives inducements in connection with business undertaken for the customer adequate disclosure of such inducements must be made to the customer.***

• **RULES**

8. If an investment firm has entered into a soft commission or is to receive any other form of inducement in connection with business undertaken for the customer, the customer must be informed in writing of the relevant details of such inducements prior to the provision of any services.
9. Where an investment firm has received any form of inducement in the course of business undertaken for the customer, it must inform the customer at least once a year in writing of the relevant details of such inducements.
10. The relevant details include in particular the percentage of the commission returned to the investment firm, the value of goods or services received by the investment firm, a summary of those goods and services and an explanation of the investment firm's policy on inducements.

**1.4 COMPLIANCE**

• **PRINCIPLES**

- 11. An investment firm must establish an independent compliance function, aimed at ensuring that their directors, partners, employees and agents behave in the best interests of its customers and the integrity of the market.**
- 12. Executive directors/senior management must take reasonable measures to ensure that the investment firm is acting in the best interests of its customers by establishing and implementing adequate compliance policies and procedures.**
- 13. An investment firm must be able to demonstrate that it has acted in compliance with the conduct of business rules and that its organisation, policies and procedures facilitate such compliance.**

• **RULES**

14. The persons responsible for the compliance function must have the necessary resources and authority and shall perform their monitoring duties independently. The results of the monitoring must be reported objectively to the senior management of the investment firm on a periodic basis.
15. The compliance function must:
  - a) continuously verify the adequacy of policies and procedures to ensure compliance with the applicable regulations;
  - b) develop policies and procedures to handle and follow up customer complaints and keep a register of customer complaints and the measures taken for their resolution;
  - c) provide advisory assistance and support to the various business areas of the investment firm on problems concerning the provision of investment services, potential conflicts of interest and the appropriate actions.
16. The persons responsible for the compliance function must have full access to all relevant information enabling them to perform their duties.
17. An investment firm must keep relevant records for a period of five years in order to enable the supervisory authority to verify compliance with the conduct of business rules.

18. An investment firm must inform the regulatory authorities of any serious breach of the conduct of business rules and the corresponding remedies immediately. Material breaches and remedies must be reported annually.

## **1.5 CODE OF CONDUCT**

### **• PRINCIPLE**

- 19. An investment firm must adopt and ensure compliance with an appropriate internal code of conduct.**

### **• RULE**

20. An investment firm must establish a code of conduct for members of the supervisory board, directors, partners, employees and agents or any person who has access to inside or customer information, including third parties (e.g. advisors, external auditors). The code of conduct must contain:
- a) the obligation to protect data of a confidential nature;
  - b) the rules and procedures for carrying out personal transactions involving financial instruments;
  - c) the rules and procedures governing the business relationship with customers in order to ensure that the persons referred to above, in particular where a conflict of interest may arise, always act in the best interests of customers, and that such persons do not take advantage of any confidential information;
  - d) the investment firm's policy on inducements.

## **2. INFORMATION TO BE PROVIDED TO CUSTOMERS**

### **2.1) BASIC REQUIREMENTS**

### **• PRINCIPLES**

- 21. An investment firm must pay due regard to the information needs of its customers and communicate information to them, which is fair, clear, and not misleading.**
- 22. An investment firm must supply its customers with all the relevant information to enable them to make informed investment decisions.**
- 23. An investment firm must provide customers with all information on a timely basis.**

### **• RULES**

24. The firm must ensure that information provided to customers is clear and comprehensible. The content and purpose of the information should be easily understood and key items should be given due prominence. The impact of the message should not be diminished or obscured by the use of inappropriate content or presentation.

25. The investment firm must take into consideration the time necessary for a customer to absorb and react to the information provided and must supply its customers with information on a prompt basis according to the urgency of the situation.
26. If information provided contains comparisons, the requirement of being fair, clear and not misleading means that the comparisons must:
  - a) be based either on facts verified by the investment firm, or on assumptions stated within the information;
  - b) be presented in a fair and balanced way;
  - c) not omit any fact that is material to the comparison.

## **2.2) INFORMATION TO BE PROVIDED TO CUSTOMERS BEFORE THE PROVISION OF INVESTMENT SERVICES**

### **2.2.1) MARKETING COMMUNICATIONS**

#### **• PRINCIPLES**

27. ***If an investment firm issues a marketing communication, the promotional purpose of marketing communications must not be disguised.***
28. ***If an investment firm provides information in a marketing communication, it must be adequate in light of the context, fair, clear and not misleading, according to the principles and rules in this chapter.***

#### **• RULES**

29. An investment firm must be able to demonstrate that the information provided in a marketing communication is consistent with the information it provides to its customers before and during the provision of the investment services.
30. Any marketing communication must contain at least the information about the investment firm defined in points a) and d) of paragraph 35. In case of a cross border marketing communication, the information provided must in addition state that information about the firm can also be obtained from or through the competent authority of the Member State where the customer resides.
31. An investment firm must not use the name of the competent authority to endorse its marketing communication or services.
32. Where a marketing communication refers to a financial instrument or an investment service it must provide at least the information referred to in points a) and d) of paragraph 39.

## **2.2.2) INFORMATION ABOUT THE INVESTMENT FIRM**

### **• PRINCIPLES**

- 33. Prior to the provision of investment services, a investment firm must provide customers with adequate information about itself and the services it provides.**
- 34. Prior to the provision of investment services, an investment firm must inform it's customers of the nature and extent of any material conflict between its own interests (or those of an affiliated person) and any duties it owes to the customer.**

### **• RULE**

35. An investment firm must provide customers with the following information prior to the provision of investment services:
- a) the identity of the investment firm, its postal address and telephone number;
  - b) the financial group to which the investment firm belongs;
  - c) the identity and status within the investment firm of employees and other relevant agents with whom the customer has or is to have contact;
  - d) the fact that the investment firm is authorised and/or registered and the name of the competent authority that has authorised and/or registered it;
  - e) the legal capacity in which the investment firm acts and the functions that it performs so that that the customer is able to assess the scope of the firm's responsibilities;
  - f) details of the relevant compensation scheme;
  - g) details of any relevant out-of-court complaint and redress mechanism and how the customer can access it;
  - h) any existing or potential conflicts of interest between the investment firm and its customer and an outline of the firm's policies in relation to conflicts of interest;
  - i) the languages in which the customer can communicate with the investment firm.

## **2.2.3) INFORMATION ON FINANCIAL INSTRUMENTS AND INVESTMENT SERVICES**

### **• PRINCIPLES**

- 36. Prior to the provision of investment services, an investment firm must inform customers of the key features of investment services and financial instruments envisaged, according to the nature of such instruments and services, and having regard to the knowledge and experience of such customers.**
- 37. If information provided by an investment firm refers either to the past performance or to a forecast of the future performance of a financial instrument or investment service, this information must be relevant to the instrument or service being promoted and the source of the information must be stated.**



• **RULES**

38. An investment firm must inform potential customers of the key features of financial instruments and investment services. This information must consist of a description of the type of instruments and services that must be in line with the firm's assessment of the customer's knowledge and experience and having regard to any relevant facts disclosed by the customer.
39. The information provided to customers must include the following:
  - a) a description of the main characteristics of the instrument/service, including the nature of the financial commitment, whether they are traded on a regulated market or not and the risks involved;
  - b) price, including commissions, fees and other charges, of the instrument/service;
  - c) arrangements for payment and performance;
  - d) details on any cancellation rights or rights of reflection that may apply.
40. In order to give a fair and adequate description of the investment service or financial instrument being promoted, an investment firm must avoid accentuating the potential benefits of an investment service or financial instrument without also giving a fair indication of the risks.
41. The fair and adequate description of a compound product must contain all the relevant characteristics of the composing instruments. The 'relevant characteristics' of a compound product means all the different characteristics of the product, for example the different services involved, the duration of the product, the fact whether you borrow money, the interest due, etc.
42. The information on financial instruments and investment services must not state or imply that the performance of services or of the investment is guaranteed unless there is a legally enforceable arrangement with a third party who undertakes to meet in full an investor's claim under the guarantee. Sufficient detail about the guarantor and the guarantee must be provided to enable the investor to make a fair assessment of the guarantee.
43. When information provided refers to a particular tax treatment the investment firm must remind the customer that the taxation depends on his or her personal situation and that the tax treatment is subject to change. In any event the investment firm must recommend to the customer to seek independent tax advice.
44. If a reference to historical performance of investment services or financial instruments is made, it must be clearly expressed that the figures refer to the past, and that they do not constitute reliable guidance as to the performance of these services and instruments in the future.
45. Any estimate, forecast or promise contained in the information on financial instruments and investment services must be clearly expressed, must state the assumptions on which it is based, must be relevant and must not mislead the customer.
46. If the information refers to actual returns based on past performance:
  - a) the reference period must be stated and must not be less than one year, provided that the relevant data are available;
  - b) where returns relate to more than one year, they must either be reduced to an average annual rate or stated separately as annual returns;



- c) where an average annual return is presented for more than one year, a reference period of at least five years must be used provided the relevant data are available. If the relevant data are not available over a reference period of at least five years (e.g. because the financial instrument or the investment portfolio has not existed for such a period), the returns may be measured from the issue date or the date on which the portfolio was established;
  - d) where a benchmark is used to compare returns, it must be identified and its reference period must be equal to that of the investment service or financial instrument being promoted;
  - e) the information provided must, if simulated returns are used, state that a simulation has been used;
  - f) if the return figures are not denominated in local currency, the currency used must be stated and reference shall be made to the currency risk for the return in local currency.
47. The relevant provisions on actual returns shall apply mutatis mutandis to the method of calculating and presenting the future returns. Information on estimated future returns must state that the estimated future returns are forecasts and that the forecasts are supported by figures and have been subject to verification by an independent third party.
48. A direct offer marketing which promotes a specific financial instrument or investment service must contain a fair and adequate description of the instrument or service, including the risks involved, so as to enable potential customers to make an informed assessment of such instrument or service.
49. A direct offer marketing must contain a prominent statement that, if a customer has any doubt about the product or service which is the subject of the marketing communication, he should contact the investment firm for advice or contact an independent intermediary if the investment firm does not offer advice.

### **Derivatives and leveraged transactions**

50. If the customer envisages undertaking transactions in derivatives, the information provided must relate to the types of instruments concerned (e.g. futures/options/swaps), include an explanation of their characteristics (especially the leverage effect, the duration of the premium, the liquidity and volatility of the market) and a description of their underlying parameter (e.g. equities/interest rates/currencies), and indicate the method to be used to execute the customer's transactions (in particular, on a regulated market or not).

### **2.2.4 COMMISSIONS, CHARGES AND FEES**

#### **• PRINCIPLE**

- 51. Prior to the provision of investment services, an investment firm must communicate clearly and precisely to the customer all the charges relating to the services or instruments envisaged and how the charges are calculated.**

- **RULES**

52. The information to be disclosed on commissions, charges and fees must contain:
- a) the charges for each transaction, product or service, specifying clearly the reason for the charge and detailing, where appropriate, the percentage or rate applicable, the frequency with which it is applied, any maximum or fixed minimum fees and, where the commission or fee must be paid in foreign currency, the currency involved;
  - b) if various investment firms are to be involved in a transaction or service, an indication to this effect. An investment firm may elect to establish the full cost to the customer of the transaction or service or the cost solely of its own intervention, stating in this case the items involved plus an indication of the fees relating to the participation of the other firms.

### **2.2.5 RISK WARNINGS**

- **PRINCIPLES**

- 53. An investment firm must provide its customers with appropriate risk statements that warn of the risks associated with financial instruments and transactions, having regard to the customer's knowledge, experience, investment objectives and risk profile.**
- 54. Risk warnings must be given due prominence. They must not be concealed or masked in any way by the wording, design or format of the information provided.**

- **RULES**

55. In addition to the information to be included in marketing communications and product literature the investment firm must provide its customers with specific risk warnings as appropriate. Instances where the type of instrument or transaction envisaged makes specific risk warnings necessary include:
- financial instruments not traded on a regulated market;
  - financial instruments not authorised to be marketed to the public in the country of residence of the customer;
  - transactions in illiquid financial instruments ;
  - derivatives;
  - financial instruments subject to high volatility;
  - short sales of financial instruments;
  - securities repurchase agreements or securities lending agreements;
  - foreign markets where appropriate;
  - transactions which involve credit or margin payments;
  - deposit of collateral;
  - foreign currency transactions.

As a minimum the investment firm must explain to the customer that contracts in these instruments and transactions should not be entered into unless the customer fully understands the nature and scope of the risk and appreciates the extent of the exposure to that risk.

56. Risk warnings about derivatives must disclose that the instrument can be subject to sudden and sharp falls in value. Where the investor may not only lose his entire investment but may also be required to pay more later, he must also be warned about this fact and the possible obligation to provide extra funding. In addition the risk warning must, where appropriate, carry information on:
- a) clearing house protections (e.g. that although the performance of a transaction is sometimes 'guaranteed' by the exchange or clearing house this guarantee will not necessarily protect the customer in the event of default by the investment firm or another counterparty);
  - b) suspension of trading (e.g. that under certain trading conditions it may be impossible to liquidate a position);
  - c) insolvency (e.g. that in the event of default of an investment firm involved with the customer's transaction, positions may be liquidated automatically and actual assets lodged as collateral may be irrecoverable).

### **2.3. CUSTOMER REPORTING**

#### **• PRINCIPLES**

- 57. An investment firm must ensure that customers are provided promptly with the essential information concerning the progress of execution of any transaction they undertake.**
- 58. Where an investment firm has control of, or is otherwise responsible for assets belonging to a customer, it must arrange for proper identification and confirmation of such assets to the customer in accordance with the responsibility it has accepted.**
- 59. An investment firm which operates customer accounts, which include open positions in derivatives, must provide regular statements of such positions.**

#### **• RULES**

##### **a) Confirmation of customer orders**

60. No later than the first business day following receipt of an order by an investment firm, the investment firm must send a written confirmation of the order to the customer. The confirmation-notice must include customer order details, date and time of reception and, where applicable, date and time of transmission. In the case of orders received by electronic means, an investment firm must send prompt confirmation by the same means, provided the customer can store the confirmation on a permanent medium.
61. Alternatively, where an order is executed no later than the first business day after it was received and the investment firm provides a contract note as required below, the investment firm may choose not to issue confirmation of the order.
62. Any refusal by the firm to accept or transmit a customer order, or inability to transmit it, must be notified immediately.

## **b) Contract Notes and trade confirmations**

63. No later than the first business day following the execution of the transaction the investment firm must send to the customer<sup>(4)</sup>, by fax, mail or electronic means (provided the customer can store it on a permanent medium), a contract note or confirmation notice which includes the following information:
- a) the name of the firm;
  - b) the time of execution, or a statement that the time of execution will be supplied on request;
  - c) date of execution;
  - d) the type of transaction; e.g. buy, sell, subscription etc.;
  - e) the regulated market on which the transaction was carried out or the fact that it was carried out off-market;
  - f) the financial instrument and the quantities involved in the transaction;
  - g) the unit price applied and the total consideration;
  - h) whether the customer's counterparty was the investment firm itself or any related party;
  - i) the commissions and expenses charged;
  - j) the time limit and procedure for the settlement of the transaction, e.g. details of the bank account and securities account.
64. An investment firm must immediately inform customers of orders, which were not executed.
65. If the investment firm executing a customer's orders has no relationship with the customer, it must send the above confirmation notice to the investment firm that has transmitted the order no later than the first business day following the execution, and this firm must forward the notice to the customer immediately.

## **c) Periodic information**

66. An investment firm must send to its customer at least once a year or as often as agreed with the customer a statement of all assets held in custody on behalf of each customer. The statement must also:
- a) identify assets which have been pledged to the firm or any third parties as collateral;
  - b) identify assets which have been lent;
  - c) clearly and consistently show movement of assets based on either trade date or settlement date.

## **d) Derivatives and leveraged transactions**

67. Where an account includes uncovered short positions in derivatives and/or a leveraged portfolio, an investment firm must send to its customer a monthly statement which include the following:
- a) Information about the exercise of options, e.g. date of exercise, time of exercise or whether the customer will be notified of that time on request, as well as any incidental costs connected with the exercise;

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<sup>(4)</sup> The reference to "send to the customer" includes to an agent, other than the firm, nominated by the customer in writing.

- b) each payment made and amount received by the customer as a result of the margin requirements in respect of the open positions;
- c) information in relation to each uncovered short position, the amount of the unrealised profit or loss (before deducting any commission which would be payable on a closing out of that position) attributable to that position.

### **3. THE “KNOW-YOUR-CUSTOMER PRINCIPLE” AND SUITABILITY**

#### **3.1 INFORMATION FROM THE CUSTOMER**

##### ***- PRINCIPLE***

***68. Prior to providing any investment service to a customer and throughout the business relationship, the investment firm must be in possession of the following:***

- a) documentation of the identity of the customer, as well as the identity and legal capacity of any representative of the customer,***
- b) any trading restrictions applicable to the customer,***
- c) information enabling the investment firm to determine the investment services and financial instruments that would be suitable for the customer, including the customer’s knowledge and experience in the investment field, his investment objectives and risk profile, and his financial situation/capacity.***

##### ***- RULES***

- 69. The “know-your-customer” principle applies to each investment firm having a direct business relationship with the customer. However, where several investment firms are involved in providing an investment service, a investment firm may rely on the information received from another investment firm that has a direct relationship with the customer.
- 70. An investment firm must obtain evidence of the identity of their customers in accordance with national laws and regulations implementing the provisions of Council Directive 91/308 on the prevention of the use of the financial system for the purpose of money laundering. Until such evidence is obtained, the investment firm may not provide any investment services to the customer concerned.
- 71. Before accepting any customer order for transmission or execution, the investment firm must obtain information on any trading restrictions or other comparable circumstances, which may affect the provision of services, or confirmation by the customer that he is not subject to any such restrictions.
- 72. Information on the customer’s investment knowledge and experience includes the types of services, transactions and products the customer is familiar with and his trading history, i.e. the nature, volume, frequency and timeframe of his transactions.
- 73. Information on the customer’s investment objectives and risk profile includes the temporal horizon of the customer’s investments, as well as his preferences regarding risk-taking, profitability and recurrent earnings.

74. Information on the customer's financial situation/capacity must be sought as appropriate in the context of the services rendered.
75. The customer must be advised that he should inform the investment firm of any major changes affecting his investment objectives, risk profile, financial situation/capacity, trading restrictions, or the identity or capacity of his representative. The investment firm must keep such information under regular review. Should the customer fail to provide updated information upon request, then the investment firm must make a record of this and give an appropriate warning that any refusal to supply information may adversely affect the quality of the service. Should the firm become aware of a major change in the situation previously described by the customer, it must request additional information.
76. An investment firm must draw up and implement appropriate written internal policies and procedures to keep and update all documents required for customer identification and assessment as well as records of customer addresses and telephone/fax numbers.
77. An investment firm must warn the customer that any refusal to supply information may adversely affect the quality of the service.

### **3.2 SUITABILITY OF THE SERVICE/PRODUCT FOR THE CUSTOMER**

#### **- PRINCIPLES**

- 78. An investment firm must have reasonable grounds to believe, in light of the information disclosed to it by the customer, that any transaction it recommends to a customer is suitable for him, and that any information it gives to him about a contemplated transaction is appropriate and not misleading.**
- 79. The investment firm must take reasonable care not to accept orders that are unsuitable for a customer.**
- 80. Before accepting an order for transmission or execution, the investment firm must verify that the customer has sufficient financial resources to settle the proposed transaction.**

#### **- RULES**

81. Where an investment firm receives an order regarding a transaction that it considers is unsuitable for the customer, it must advise the customer accordingly, stating the reasons why it considers it inadvisable to carry out the transaction, and providing appropriate information on the transaction, including any necessary risk warning. If the customer nonetheless confirms his intention to proceed with the transaction, the investment firm may transmit or execute the order only on the basis of written instructions or instructions given by telephone and recorded, and provided that such instructions contain an explicit reference to the warning received.

A transaction may be considered unsuitable for a customer, *inter alia*, because of the instrument involved (e.g. derivatives), because of the type of transaction (e.g. sale of options), because of the characteristics of the order (e.g. size or price specifications) or because of the frequency of the customer's trading.

82. An investment firm may accept an order without verifying the immediate availability of the funds (securities) necessary for carrying out the related purchase (sale) only if an adequate credit agreement with the customer has been signed beforehand.

### **3.3 EXECUTION-ONLY DEALING SERVICES**

#### **- PRINCIPLES**

- 83. If an investment firm only transmits or executes orders for a client, it must seek from its clients information regarding their financial situations, investment experience and objectives as regards the services requested and provide him with the information on financial instruments and risk warnings required by conduct of business rules. In this situation the investment firm will be required to obtain evidence of the customer's identity (and that of his representative if any) and information on any relevant trading restrictions. Furthermore, the firm may not accept any orders until it has obtained an acknowledgement in writing by the customer that he is aware of the limited service the investment firm is providing and understands such information and risk warnings, and verified that the customer has sufficient financial resources for the transactions.**
- 84. Where an investment firm provides an execution-only dealing service, it must not make any personal recommendation to the relevant customers.**

### **3.4 CUSTOMER REFUSAL TO PROVIDE INFORMATION**

#### **- PRINCIPLE**

- 85. If a customer refuses to provide information about his investment knowledge and experience, investment objectives and risk profile, or financial situation/capacity, the investment firm must make a record of this and the investment firm may only provide an execution-only dealing service.**

#### **- RULE**

- 86.** Appropriate information on financial instruments and general risk warnings must be provided even if the investment firm possesses no information about the customer (other than his identity, his trading restrictions and the availability of sufficient resources for the envisaged transactions, which is always required). The investment firm must warn the customer that any refusal to supply information may adversely affect the quality of the service.



## **4. CUSTOMER AGREEMENTS**

### **4.1) BASIC CUSTOMER AGREEMENT**

#### **• PRINCIPLES**

**87. Prior to providing any investment service, the investment firm must enter into a written agreement with the customer setting out the rights and obligations of the parties, a description of the services to be provided, and all other items of information necessary for the proper understanding and performance of the agreement. However, where the contract is concluded using a means of distance communication which does not allow the immediate exchange of a signed document, the written agreement may be signed subsequent to the provision of the first services provided certain conditions are met.**

**88. The customer agreement must be clear and easily understandable by the customer.**

#### **• RULES**

89. The customer agreement must contain the following items as a minimum:

- a) the identity, postal address and telephone number of each of the parties;
- b) where the customer is a legal entity, the names of the natural persons authorised to represent it for the purposes of the agreement;
- c) the investment firm's general terms for investment business,
- d) any particular terms agreed between the parties;
- e) a description of the services offered by the investment firm and the types of financial instruments to which such services relate;
- f) where a related custody service is provided directly or indirectly, adequate information on this service;
- g) the types of orders and instructions that the customer may place with the investment firm, the procedures for sending them and the alternative procedures to be used when normal procedures are unavailable;
- h) the information to be given by the investment firm to the customer regarding the performance of services including the procedures for sending the information and the type, frequency and rapidity of the information to be given;
- i) complete details of the investment firm's fees and prices, including the way in which they are calculated, the frequency with which they are to be charged, and the manner of payment;
- j) the name of the competent authority which has authorised the investment firm;
- k) details of the relevant investor compensation scheme;
- l) the law applicable to the contract, as ascertained to the best of the knowledge of the firm;
- m) the duration of the agreement and the procedures for amending, renewing, terminating or withdrawing from it;
- n) where such a procedure exists, a description of the mechanism for settling disputes between the parties such as an out-of-court complaint and redress mechanism;



- o) the actions that the investment firm shall or may take in the event the customer does not honour his obligations (e. g. payment of money due to the investment firm), in particular whether the investment firm is allowed to dispose of any of the customer's assets, the timeframe for doing so and the information to be given to the customer in such circumstances;
  - p) where transactions are to be executed outside a regulated market, the appropriate information to be provided in this respect, including information on the counterparties, in particular where the investment firm itself or another member of the same group is to act as counterparty to the customer's transactions;
  - q) the languages in which the customer can communicate with the investment firm.
90. Rather than containing all the above items itself, the contract may refer to other documents containing certain of them, i.e. the general terms of business, the types of investment services offered, the types of orders and information to be sent by the parties and the fee schedule, provided that all the contractual documents so referred to are provided to the customer prior to the signing of the contract.
91. If the only services envisaged are the reception/transmission and/or execution of orders to purchase cash financial instruments traded on a regulated market using the customer's own resources, or of orders to sell such instruments belonging to the customer, and the contract is concluded using a means of distance communication which does not allow the exchange of a signed document, the customer may request to sign the agreement subsequent to the provision of the first services, provided that the customer has received all of the items listed above (except information on the customer's identity, address, and representative). In such a case, the agreement must be received by the investment firm no later than one month after the first provision of services.
92. Where a custody service is provided, either directly by the investment firm party to the contract with the customer or indirectly by another investment firm, the contract must describe the rights and obligations of the parties. Where custody is arranged in whole or in part by another investment firm, these arrangements must be described.
93. The contract must state that any modification of the agreement by the investment firm, e.g. regarding fees, requires the prior notification of the customer, and the contract must provide a sufficient opportunity for the customer to terminate the agreement.
94. A copy of the agreement signed by the customer (and any related contractual documents) must be kept by the investment firm for the duration of the customer relationship and for at least five years after the end of the relationship; a copy must be provided to the customer immediately after signing, and at any time subsequently on request.

#### **4.1) CUSTOMER AGREEMENT INVOLVING TRADING IN DERIVATIVES**

##### **• PRINCIPLE**

95. ***Prior to providing the services of reception/transmission and/or execution of orders involving derivatives, a customer agreement containing the relevant provisions of the basic customer agreement as well as additional provisions on the following items must be signed between the parties:***
- ***the type(s) of instruments and transactions envisaged,***

- ***the obligations of the investment firm with respect to the transactions envisaged, in particular its reporting and notice obligations to the customer,***
- ***the obligations of the customer with respect to the transactions envisaged, in particular his financial commitments toward the investment firm and the time allowed for honouring such commitments,***
- ***an appropriate warning calling to the customer's attention the risks involved in the transactions envisaged.***

#### **• RULES**

96. The contract must mention the types of instruments envisaged, in particular whether they are traded on a regulated market or not, and it must refer to the documentation on such instruments provided by the investment firm to the customer for information purposes.
97. The contract must mention the types of transactions envisaged, in particular whether the customer intends to undertake transactions giving rise to contingent liabilities.
98. The contract must provide for the immediate confirmation of derivatives transactions and the immediate notice to the customer of his payment obligations as they arise, as well as the procedures to be used for such confirmation and notice.
99. The contract, or the documentation referred to in the contract, must provide full information on any margin requirements or similar obligations, regardless of the source of such rules and requirements, e.g. an exchange or clearing house, or the investment firm itself. The contract must indicate how margin will be calculated and charged, the assets (cash, securities, etc.) accepted as margin, the frequency of margin calls and the timetable for the delivery or payment of margin by the customer to the investment firm. The contract must require immediate notification to the customer of any change in margin rules.
100. The warning given to the customer should reflect the transactions envisaged, in particular where potential losses may exceed the amounts invested, as well as the experience, knowledge and financial situation/capacity of the customer, and should be given due prominence in the contract.

### **5.- DEALING REQUIREMENTS**

#### **• PRINCIPLES**

- 101. An investment firm must handle and execute a customer's order in the best interest of the customer.**
- 102. An investment firm must have resources and implement procedures in order to ensure efficient and timely order handling and execution. Back-up procedures and systems must be in place to ensure that investment services can be provided without interruption.**

## **5.1) RECEPTION AND TRANSMISSION OF CUSTOMER ORDERS**

### **• PRINCIPLES**

**103. An investment firm must ensure that orders are recorded and processed in such a way as to facilitate best execution and to ensure that ultimate execution reflects the instructions from the customer.**

**104. Orders must be transmitted promptly and sequentially. In no circumstances may orders be offset during the transmission process, unless the investment firm can demonstrate that it was in the interest of the customer.**

**105. An investment firm must ensure that the firm, its directors or employees do not take any advantage of information they possess on customers orders.**

**106. An investment firm must document and maintain records of orders received from its customers.**

### **• RULES**

#### **Reception**

107. An investment firm must ensure that, prior to the transmission, orders given by customers are clear and precise and include the following:

- a) name of the customer and, the person acting on his behalf, if any,
- b) date and time of the order,
- c) the financial instrument to be traded,
- d) the size of the order,
- e) nature of the order, e.g., subscription, buy, sell, exercise etc.,
- f) any other relevant details and particular instructions from the customer for the order to be properly transmitted and executed, e.g. limit orders, market of execution, etc.

108. An investment firm must record orders immediately, documenting and verifying all relevant items for proper execution.

109. An investment firm must keep a record of telephone orders on magnetic tape or an equivalent medium. Investment firms will duly inform the customer beforehand that the conversation is recorded.

110. Before transmitting orders on behalf of several beneficiaries on an aggregated basis, an investment firm must pre-assign such orders in order to ensure that they can identify and match the orders with the relevant customer at any time.

#### **Transmission**

111. An investment firm shall refrain from transmitting orders for its own account before those of customers in identical or better conditions than the latter ("front running").

112. An investment firm may transmit orders for its own account and for its customers account on an aggregated basis when it is clearly in the best interest of the customer and in compliance with the best execution principle.
113. In the case of orders in connection with placements, an investment firm may transmit such orders provided that they offer the relevant prospectus to the customer or informs the customer where it is available, and the customer confirms that he is aware of the existence of the said prospectus.

## **5.2) EXECUTION OF ORDERS**

### **• PRINCIPLES**

- 114. An investment firm must obtain the best possible result for the customer with reference to price, costs born by the customer, size, nature of the transactions, time and place, taking into account the state of the relevant markets.**
- 115. An investment firm must execute orders according to the time priority of their reception, unless market conditions require otherwise in the interest of the customer.**
- 116. An investment firm must provide the customers with information of relevant risks or impediments for the proper execution of the orders. Failure to execute an order must be promptly communicated to the customer.**

### **• RULES**

117. An investment firm acting as agent provides best execution if it takes reasonable care to obtain the result which is the best available for the customer in the relevant market(s). The relevant market(s) shall be deemed to be the best market(s) accessible in terms of conditions, transparency, liquidity and clearing and settlement in connection with the envisaged transaction. If the investment firm executes in another market, it must demonstrate to the customer that this was in his best interest.

If the investment firm is acting as principal, it must prior to entering into the transaction inform the customer of this fact, of the price it is prepared to deal at and the corresponding price(s) and volume(s) in the relevant market(s).

118. The price received or paid by the customer shall be identified separately from the total consideration, which will include all costs.
119. If, due to market conditions, an order cannot be executed according to the instructions given by the customer and the customer cannot be contacted, the investment firm must act in the best interest of the customer and ensure that the customer is duly informed as soon as possible.

## **5.3) POST- EXECUTION OF ORDERS**

### **• PRINCIPLES**

- 120. An investment firm must establish internal policies for the proper allocation and distribution of executed transactions.**

**121. Where trades for own and customers accounts have been aggregated, the investment firm must not allocate in any way detrimental to any customer. If transactions are only partially executed, allocation to customers takes priority over allocation to the investment firm.**

• **RULES**

122. An investment firm must ensure that once a transaction is executed it is promptly recorded and allocated to the account of the customer(s) or to the account of the investment firm, which collected and transmitted the order.
123. An investment firm shall record the essential elements of transactions, including those carried out for its own account, immediately after their execution. An investment firm shall record in an analogous manner the orders they give and the transactions they carry out for the purpose of dealing with errors in recording, transmitting or executing orders.
124. When, in the best interest of the customer, an order is to be executed in several tranches, the investment firm must inform the customer about the price of execution of each tranche.
125. If aggregated orders are partially executed the customer must be informed of the investment firm's internal reallocation policy. In absence of such a policy, the investment firm shall always allocate the executed transactions on the basis of proportionality.
126. An investment firm must have procedures in place to prevent that reallocation of principal transactions executed along with customers transactions on an aggregated basis give unfair preference to the investment firm or to any of those for whom it deals.

## **6. DISCRETIONARY PORTFOLIO MANAGEMENT**

In addition to the foregoing principles and rules, additional provisions apply to the service of portfolio management.

### **6.1. CUSTOMER AGREEMENTS FOR DISCRETIONARY PORTFOLIO MANAGEMENT**

- **PRINCIPLES**

**127. Prior to the provision of any discretionary portfolio management service, a customer agreement containing the relevant provisions of the basic customer agreement mentioned above as well as additional provisions on the following items must be signed between the parties:**

- a) the management objective(s) and any specific constraints on discretionary management,**
- b) the types of financial instruments that may be included within the portfolio and the types of transactions that may be carried out in such instruments, including any related limits,**
- c) the benchmark against which performance will be compared,**
- d) the reporting obligations to the customer,**
- e) the procedure for exercising voting rights attached to the securities held in the portfolio,**

**f) details regarding the delegation of the management function where this is permitted.**

**128. Where the conditions for delegating management of the portfolio are met and the contract allows the investment firm to delegate this function, the contract must state that the delegator retains full responsibility for the protection of the investor's interests.**

**- RULES**

129. The contract must indicate the objectives of the customer and the level of risk agreed upon, as well as the involvement of the customer, if any, in the investment decisions (where this is allowed by the applicable regulations), and any particular constraints on discretionary management resulting from the customer's personal circumstances (such as trading restrictions) or his request to exclude certain types of investments (certain business sectors for example).
130. If the investment firm is authorised to invest in any of the following types of instruments or to undertake any of the following types of transactions, the contract must state so explicitly and provide adequate information on the scope of the investment firm's discretionary authority regarding these instruments and transactions:
- financial instruments not traded on a regulated market, or not authorised to be marketed to the public in the country of residence of the customer,
  - short sales of securities,
  - securities repurchase agreements or securities lending agreements,
  - derivatives (e.g warrants, futures, options, contracts for differences),
  - foreign markets where appropriate,
  - transactions which involve credit or margin payments,
  - deposit of collateral,
  - foreign currency transactions.
131. The contract must indicate a benchmark that is consistent with the customer's objectives and risk profile, and against which the results of portfolio management are to be compared. Such benchmark must be based on financial indicators produced by third parties and in common use.
132. The contract must specify the information to be given to the customer regarding the portfolio and the periodicity of this information.
133. The contract must define a specific reporting requirement in the event of losses. It must set a threshold and a time period to warn the customer accordingly.
134. If the contract provides for a variable management fee based on the performance of the management service, the method of calculation must be clearly defined in the contract.
135. The contract must provide that either the customer or the investment firm may terminate the portfolio management agreement subject only to a maximum of one week's notice, and on terms that are fair and reasonable for both parties.

## **Delegation of portfolio management**

136. If the investment firm is authorised to delegate management of any or all of the assets, this must be stated in the contract and adequate information must be supplied in this regard. The contract must also provide that the customer will be informed prior to any significant change regarding delegation of portfolio management.
137. The investment firm may delegate the portfolio management function to another investment firm only if such delegate firm is authorised in its home country to provide portfolio management services on an individual basis. Furthermore, it may so delegate to a non-EEA investment firm only if an appropriate formal arrangement between regulators enables them to exchange material information concerning both cross border delegations and the delegates.
138. The delegation agreement, in writing:
- a) must be revocable with immediate effect by the delegator;
  - b) must provide for sufficient notice to be given to the delegator by the delegate of termination of the agreement;
  - c) must be in conformity with the indications contained in the customer agreement with the delegator;
  - d) must require, where the execution of transactions is not subject to the prior consent of the delegator, the delegate to observe the investment guidelines laid down from time to time by the delegator;
  - e) must be formulated so as to avoid conflicts of interest between the delegator and the delegatee;
  - f) must provide for the delegator to receive a continuous flow of information on the transactions carried out by the delegate permitting the exact reconstruction of the assets under management belonging to each customer of the delegator.

## **6.3 PERIODIC INFORMATION**

### **- PRINCIPLES**

**139. An investment firm must periodically provide its portfolio management customers with clear, comprehensive and timely information on the management of the portfolio and its results.**

**140. An investment firm must send periodic statements to its customers. Periodic statements must include a statement of the market value of the portfolio, the fees and charges for the period and information on any remuneration received from a third party relating to transactions entered into in connection with the portfolio.**

### **- RULES**

141. Periodic statements for portfolio management customers must contain:
- a) a statement of the contents and valuation of the portfolio, including details of each investment held, its market value (or other valuation) and the cash balance;



- b) the basis on which the instruments are assessed at the date of valuation, e.g. whether the instruments are priced at bid/ask or offer, mid market price or, where relevant, by reference to indicators such as yield curves, pricing models, etc., including any relevant currency exchange rates;
  - c) details of each transaction undertaken during the period or, when the customer has received contract notes in respect of all transactions, a summary of the transaction activity during the period;
  - d) the total amount of fees and charges incurred during the period;
  - e) the total amount of dividends, interest and other payments received during the period.
142. In its periodic statement to customers, an investment firm must value unlisted instruments with reference to the market value of related listed and other financial instruments.
143. If the basis for valuing the relevant instruments has changed since the previous valuation report, this must be specified in the statement along with the corresponding profits and/or losses.
144. Periodic statements must include full information on any remuneration received by the investment firm or the manager from a third party that is attributable to services performed for the customer by the manager of the portfolio.
145. Where the customer does not receive immediate information on each transaction carried out by the portfolio manager, information on the market value and composition of the portfolio (at the beginning and at the end of the reporting period) must be provided at least every three months. Where each transaction is notified to the customer, information on the market value and composition of the portfolio may be given only every six months. In all cases explanatory information on portfolio management decisions taken during the reporting period must be sent to the customer at least every six months.
146. Where the contract authorises leveraged portfolio, the customer shall receive a periodic statement at least once a month, including an assessment of the risks.

## **6.4 MANAGEMENT REQUIREMENTS**

### **- PRINCIPLES**

- 148. An investment firm shall ensure that all its portfolio management customers are treated fairly.**
- 149. An investment firm must take all steps necessary to ensure the independence of the portfolio management function and mitigate the risk of customers' interests being harmed by any conflict of interest, in particular by providing for the strict separation of functions within the investment firm and its group.**
- 150. An investment firm must define investment strategies for its portfolio management services and carry out transactions in accordance with such strategies taking into account the terms of the customer agreement and, where applicable, any particular instructions given by the customer.**
- 151. The transactions carried out by the portfolio manager, both individually and as a whole, must be exclusively motivated by the interests of the customer and in accordance with customer objectives and instructions.**





- **RULES**

152. The structure of the investment firm, its policies and procedures must guarantee the independence of the portfolio management function.
153. The investment firm shall maintain records of its investment strategies, as well as the analyses and forecasts underlying them.
154. An investment firm shall ensure that its orders are executed in the best manner possible and in particular that:
  - a) orders are recorded by the portfolio management firm immediately;
  - b) transactions are executed and recorded and the portfolios affected are adjusted as quickly as possible;
  - c) the portfolios affected and the relevant amounts are determined no later than the time at which the order is issued and cannot be changed after the execution of the order, regardless of whether the order relates to one or more accounts.

## **IV. CORE CONDUCT OF BUSINESS RULES FOR PROFESSIONALS**

### **1. PRINCIPLES AND RULES OF GENERAL APPLICATION**

#### **• PRINCIPLES**

- 1. *An investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of a professional<sup>(5)</sup>.***
- 2. *An investment firm that delegates or outsources any services to other providers, shall ensure that the choice of the latter is based on their ability to perform the services professionally and in the best interests of a professional.***
- 3. *An investment firm must refrain from doing business with any other firm that has not obtained the required authorisation.***

### **1.2 CONFLICTS OF INTEREST**

#### **• PRINCIPLE**

- 4. *An investment firm must take all reasonable steps to ensure that conflicts of interest between itself and its professional customers and between one professional customer and another are managed in such a way that the interests of the professional customers are not adversely affected.***

### **1.3 COMPLIANCE**

#### **• PRINCIPLES**

- 5. *An investment firm must establish an independent compliance function, aimed at ensuring that their directors, partners, employees and agents behave in the best interests of its professional customers and the integrity of the market.***
- 6. *Executive directors/senior management must take reasonable measures to ensure that the investment firm is acting in the best interests of its professional customers by establishing and implementing adequate compliance policies and procedures.***
- 7. *An investment firm must be able to demonstrate that it has acted in compliance with the conduct of business rules and that its organisation, policies and procedures facilitate such compliance.***

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<sup>(5)</sup> The professional can be a professional customer or a counterparty. Chapter IV is divided in neutral sections (which regard both professional customers and counterparties), sections regarding customer orders (which regard to professional customers) and sections regarding principal trading (which regards to counterparties).

- **RULES**

8. The persons responsible for the compliance function must have the necessary resources and authority and shall perform their monitoring duties independently. The results of the monitoring must be reported objectively to the senior management of the investment firm on a periodic basis.
9. The compliance function must:
  - a) continuously verify the adequacy of policies and procedures to ensure compliance with the applicable regulations;
  - b) develop policies and procedures to handle and follow up customer complaints and keep a register of customer complaints and the measures taken for their resolution ;
  - c) provide advisory assistance and support to the various business areas of the investment firm on problems concerning the provision of investment services, potential conflicts of interest and the appropriate actions.
10. The persons responsible for the compliance function must have full access to all relevant information enabling them to perform their duties.
11. An investment firm must keep relevant records for a period of five years in order to enable the supervisory authority to verify compliance with the conduct of business rules.
12. An investment firm must inform the regulatory authorities of any serious breach of the conduct of business rules and the corresponding remedies immediately. Material breaches and remedies must be reported annually.

#### **1.4 CODE OF CONDUCT**

- **PRINCIPLE**

**13. An investment firm must adopt and ensure compliance with an appropriate internal code of conduct.**

- **RULE**

14. An investment firm must establish a code of conduct for members of the supervisory board, directors, partners, employees and agents or any person who has access to inside or customer information, including third parties ( e.g. advisors, external auditors). The code of conduct must contain :
  - a) the obligation to protect data of a confidential nature ;
  - b) the rules and procedures for carrying out personal transactions involving financial instruments;
  - c) the rules and procedures governing the business relationship with customers in order to ensure that the persons referred to above, in particular where a conflict of interest may arise, always act in the best interests of customers, and that such persons do not take advantage of any confidential information.
  - d) the investment firm's policy on inducements.

## **2. INFORMATION TO BE PROVIDED TO PROFESSIONALS**

### **• PRINCIPLE**

- 15. An investment firm must pay due regard to the information needs of an professional and communicate information to them which is fair, factually accurate, and not misleading.**

### **2.1) INFORMATION TO BE PROVIDED TO PROFESSIONALS BEFORE THE PROVISION OF INVESTMENT SERVICES**

### **• PRINCIPLE**

- 16. An investment firm must provide an professional with the information as required in article 5 of the E-commerce Directive of the EU.**

## **3. THE KNOW-YOUR-CUSTOMER PRINCIPLE AND SUITABILITY**

### **3.1 INFORMATION FROM THE PROFESSIONAL CUSTOMER**

### **- PRINCIPLE**

- 17. Prior to providing any investment service to or entering into a transaction with an professional and throughout the business relationship, the investment firm must be in possession of the following:**
- a) documentation of the identity of the professional, as well as the identity and legal capacity of any representative of the professional. An investment firm must obtain evidence of the identity of professionals in accordance with national laws and regulations implementing the provisions of Council Directive 91/308 on the prevention of the use of the financial system for the purpose of money laundering. Until such evidence is obtained, the investment firm may not provide any investment services to an professional concerned;**
  - b) any relevant trading restrictions applicable to the professional.**

## **4. DEALING REQUIREMENTS FOR PROFESSIONAL CUSTOMER ORDERS**

### **• PRINCIPLES**

- 18. An investment firm must handle and execute a professional's order in the best interest of the professional.**
- 19. An investment firm must have resources and implement procedures in order to ensure efficient and timely order handling and execution. Back-up procedures and systems must be in place to ensure that investment services can be provided without interruption.**

#### **4.1) RECEPTION AND TRANSMISSION OF PROFESSIONAL CUSTOMER ORDERS**

##### **• PRINCIPLES**

- 20. An investment firm must ensure that orders are recorded and processed in such a way as to facilitate best execution and to ensure that ultimate execution reflects the instructions from the professional customer.**
- 21. Orders must be transmitted promptly and sequentially . In no circumstances may orders be offset during the transmission process, unless the investment firm can demonstrate that it was in the interest of the customer..**
- 22. An investment firm must ensure that the firm, its directors or employees do not take any advantage of information they possess on professional customers orders.**
- 23. An investment firm must document and maintain records of orders received from its professional customers.**

##### **• RULES**

###### **Reception**

24. An investment firm must ensure that, prior to the transmission, orders given by professional customers are clear and precise and include the following:
  - a) name of the professional customer and, the person acting on his behalf, if any,
  - b) date and time of the order,
  - c) the financial instrument to be traded,
  - d) the size of the order
  - e) nature of the order, e.g., subscription, buy, sell, exercise etc.,
  - f) any other relevant details and particular instructions from the professional customer for the order to be properly executed, e.g. limit orders, market of execution, etc.
25. An investment firm must record orders immediately, documenting and verifying all relevant items for proper execution.
26. An investment firm must keep a record of telephone orders and other transactions on magnetic tape or an equivalent medium. Investment firms will duly inform the professional customer beforehand that the conversation is recorded.
27. Before transmitting orders on behalf of several beneficiaries on an aggregated basis, an investment firm must pre-assign such orders in order to ensure that they can identify and match the orders with the relevant professional customer at any time.

###### **Transmission**

28. An investment firm shall refrain from transmitting orders for its own account before those of professional customers in identical or better conditions than the latter ("front running").
29. An investment firm may transmit orders for its own account and for its professional customers account on an aggregated basis when it is clearly in the best interest of the professional customer and in compliance with the best execution principle.

#### **4.2) EXECUTION OF ORDERS**

##### **• PRINCIPLES**

- 30. An investment firm acting as an agent must obtain the best possible result for the professional customer with reference to price, costs born by the professional customer, time, place, size and nature of the transactions, taking into account the state of the relevant markets.**
- 31. An investment firm must execute orders according to the time priority of their reception, unless market conditions require otherwise in the interest of the professional customer.**
- 32. An investment firm must provide the professional customer with information of relevant risks or impediments for the proper execution of the orders. Failure to execute an order must be promptly communicated to the professional customer.**

##### **• RULES**

33. An investment firm acting as agent provides best execution if it takes reasonable care to obtain the price which is the best available for the professional customer in the relevant market(s). The relevant market(s) shall be deemed to be the best market(s) accessible in terms of conditions, transparency, liquidity and clearing and settlement in connection with the envisaged transaction. If the investment firm executes in another market, it must demonstrate to the professional customer that this was in his best interest.

#### **4.3) POST- EXECUTION OF ORDERS**

##### **• PRINCIPLES**

- 34. An investment firm must establish internal policies for the proper allocation and distribution of executed transactions.**
- 35. Where trades for own and professional customers accounts have been aggregated, the investment firm must not allocate in any way detrimental to any customer. If transactions are only partially executed, allocation to customers takes priority over allocation to the investment firm.**

##### **• RULES**

36. An investment firm must ensure that once a transaction is executed it is promptly recorded and allocated to the account of the customer(s) or to the account of the investment firm which collected and transmitted the order.
37. An investment firm shall record the essential elements of transactions, including those carried out for its own account, immediately after their execution. An investment firm shall record in an analogous manner the orders they give and the transactions they carry out for the purpose of dealing with errors in recording, transmitting or executing orders.
38. If an investment firm is in response to a professional's order acting as principal, it must prior to entering into the transaction inform the professional customer of this fact.

#### **4.4) DEALING REQUIREMENTS FOR PRINCIPAL TRADING**

- **PRINCIPLES**

**39. *An investment firm must document and maintain records of orders received from an professional.***

- **RULES**

40. An investment firm must ensure that, prior to a transaction, information of a professional is clear and precise and include the following:
- a) name of the professional, the person acting on his behalf, if any,
  - b) date and time of the order,
  - c) the financial instrument to be traded,
  - d) the size of the order
  - e) nature of the order, e.g., subscription, buy, sell, exercise etc.,
  - f) any other relevant details and particular instructions from the professional for the transaction to be properly executed.
41. An investment firm must record transactions immediately, documenting and verifying all relevant items.
42. An investment firm must keep a record of telephone orders and other transactions on magnetic tape or an equivalent medium.

#### **5. DELEGATION OF PORTFOLIO MANAGEMENT**

- **RULES**

43. Where the conditions for delegating management of the portfolio are met and the contract allows the investment firm to delegate this function, the contract must state that the delegator retains full responsibility for the protection of the investor's interests.
44. An investment firm may delegate the portfolio management function to another investment firm only if such delegatee firm is authorised in its home country to provide portfolio management services on an individual basis. Furthermore, it may so delegate to a non-EEA investment firm only if an appropriate formal arrangement between regulators enables them to exchange material information concerning both cross border delegations and the delegates.



## **V. ANNEXES**

- **Annexe 1: FESCO Paper on the categorisation of investors for the purpose of conduct of business rules (OO-FESCO-A)**

March 2000





- Introduction
- Criteria for defining professional investors:
  - I. Categories of investors who are considered to be professionals
  - II. Investors who may be treated as professionals on request
    - II.1 Identification criteria
      - a) Large and institutional investors
      - b) Other investors
    - II.2. Procedure

## Introduction

1. Article 11 of the Investment Services Directive (ISD) states that rules implementing its principles must be applied in such a way as to take into account the professional nature of the person for whom the service is provided. In accordance with this provision, conduct of business rules must take account of the client's knowledge and experience in the area of investment services and instruments.
2. For the members of FESCO<sup>(6)</sup>, implementing an appropriate differentiation between categories of investors for the purposes of the conduct of business regime is a necessary complement to the process of harmonising conduct of business rules. Together, progress on these two issues should contribute to an increase in the flow of financial services within the European Economic Area, by making regulation both more uniform (and therefore easier to comply with) and less prescriptive for professional clients.
3. While other investors will require a level of protection that reflects their lesser expertise, professional investors need fewer externally imposed protections. Professionals may be expected to be able to protect their own interests as well as those of their clients. In any case of course, investment firms will not only be expected to be able to protect the interests of their clients, they will be legally required to protect them, by conduct of business rules or otherwise.
4. For the members of FESCO, this implies that certain investors considered to be professionals (as defined below) may be presumed to be experts in all investment services and products, or at least sufficiently knowledgeable and prudent to take the initiative of seeking additional information and advice where this appears necessary for a particular transaction or type of transaction (in such circumstances they may request a higher level of protection as described below).
5. The members of FESCO agree that conduct of business rules should include a definition of the professional investor and provide for a streamlined application thereof to such investors in order to avoid over-burdensome regulation.

This does not mean that the provision of investment services between professional investors should not be subject to any conduct of business rules, but that there is no need in such situations for the full range of detailed investor protection rules. Only a few general principles, and possibly a limited number of standards for certain specific types of services and transactions, as well as any additional rules agreed by the parties concerned, should apply to inter-professional relationships.

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<sup>6</sup> The Forum of European Securities Commissions (FESCO) assembles the following 17 Statutory Securities Commissions of the European Economic Area (EEA): Bundes-Wertpapieraufsicht (Austria); Commission bancaire et financière/Commissie voor het Bank- en Financiewezen/ Kommission für das Bank- und Finanzwesen (Belgium); Finanstilsynet (Denmark); Rahoitustarkastus (Finland); Commission des opérations de bourse (France); Bundesaufsichtsamt für den Wertpapierhandel (Germany); ΕΠΙΤΡΟΠΗ ΚΕΦΑΛΑΙΑΓΟΡΑΣ / Capital Market Commission (Greece); Financial Supervisory Authority (Iceland); Central Bank of Ireland; Commissione Nazionale per le Società e la Borsa (Italy); Commission de surveillance du secteur financier (Luxembourg); Stichting Toezicht Effectenverkeer (Netherlands); Kredittilsynet (Norway); Comissão do Mercado de Valores Mobiliários (Portugal); Comisión Nacional del Mercado de Valores (Spain); Finansinspektionen (Sweden); Financial Services Authority (United Kingdom). The European Commission attends FESCO meetings as an observer. The Chairman of the IOSCO European Regional Committee is also invited as an observer. FESCO is chaired by Georg Wittich, Chairman of the Bundesaufsichtsamt für den Wertpapierhandel (Germany). The Conseil des marchés financiers (France) participates in meetings of the expert group on investor protection. The Secretariat of FESCO is located: 17 place de la Bourse, 75082 PARIS CEDEX 02 (Tel.: 33.1.53.45.63.61, fax.: 33.1.53.45.63.60).

6. FESCO members will seek to implement the definitions and standards set out in this paper in their regulatory objectives and, when possible, in their respective rules. If a FESCO member does not have the authority to implement a certain definition or standard, it will commend the definition or standard to its government and to the responsible regulatory authority.
7. The members of FESCO wish to stress that the conduct of business regime for professionals is an exceptional regime, i.e. it should be considered as an exception to the application of the standard conduct of business rules which aim to ensure adequate protection for less sophisticated investors.

The common implementation of the principles set out in article 11 of the ISD by FESCO is designed to give investment firms clear and reliable guidance while protecting the interests of investors.

8. The members of FESCO recognise that the implementation of the definition of professional investor is inevitably linked to the contents of the relevant rules of conduct.

As the determination of comprehensive common standards on conduct of business rules warrants further study (currently underway), the scope of this paper is limited to the criteria that should be used to categorise investors as professionals.

FESCO is also committed to drafting standards at a later stage defining the conduct of business regime that will apply to inter-professional relationships. The members of FESCO will come back to this paper to consider whether the harmonised standards are suitable for the proposed categories of professional investors.

## **Criteria for defining professional investors**

9. Professional investors are those who may be deemed to possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks they incur.

### **I. Categories of investors who are considered to be professionals**

10. The members of FESCO agree, subject to what is said below in §11, that the following should all be regarded as professionals in all investment services and instruments described in the Annex of the ISD.
  - a) Entities which are required to be authorised or regulated to operate in the financial markets

The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned: entities authorised by a Member State under a European Directive, entities authorised or regulated by a Member State without reference to a European Directive, and entities authorised or regulated by a non-Member State:

- Credit institutions<sup>(7)</sup>,
- Investment firms<sup>(8)</sup>,
- Other authorised or regulated financial institutions <sup>(9)</sup>
- Insurance companies.<sup>(10)</sup>
- Collective investment schemes and management companies of such schemes,
- Pension funds and management companies of such funds.

b) National governments, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.

11. The entities mentioned in §10 are considered to be professionals. They must however be allowed to request non-professional treatment and investment firms may agree to provide a higher level of protection.

It is the responsibility of the client considered to be a professional investor to ask for a higher level of protection when it deems it is unable to properly assess or manage the risks involved.

This higher level of protection will be provided when an investor who is considered to be a professional enters into a written agreement with the investment firm to the effect that it shall not be treated as a professional for the purposes of the applicable conduct of business regime. Such agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction.

## **II. Investors who may be treated as professionals on request**

### **II.1 Identification criteria**

#### **a) Large and institutional investors**

12. The members of FESCO consider that the following investors will often not require the full protection of Conduct of Business Rules:
- a) financial institutions other than those mentioned in §10,
  - b) large companies and partnerships,
  - c) institutional investors other than those mentioned in §10 whose corporate purpose is to invest in financial instruments,
  - d) commodity dealers;

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<sup>(7)</sup> Within the meaning of the first indent of Article 1 of Directive 77/780: "Credit Institution" means an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account."

<sup>(8)</sup> Within the meaning of point 2 of Article 1 of Directive 93/22: "Investment firm" shall mean any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis. For the purposes of this Directive, Member States may include as investment firms undertakings which are not legal persons if:  
- their legal status ensures a level of protection for third parties' interests equivalent to that afforded by legal persons, and  
- they are subject to equivalent prudential supervision appropriate to their legal form."

<sup>(9)</sup> Within the meaning of article 1 (6) of Directive 89/646/EEC.

<sup>(10)</sup> Within the meaning of article 1 of Directive 73/239/EEC or article 1 of Directive 79/267/EEC or undertaking carrying on reinsurance and retrocession activities referred to in Directive 64/225/EEC.

- e) public sector bodies<sup>(11)</sup>,
- f) issuers of listed financial instruments, i.e. entities whose securities (equity instruments or other) are traded on a regulated market<sup>(12)</sup>.

Investment firms should therefore be allowed to treat any of the above investors as professionals provided the relevant criteria and procedure mentioned below are fulfilled. These investors should not, however, be presumed to possess market knowledge and experience comparable to that of the authorised, regulated financial entities listed in §10.

- 13. The large companies and partnerships referred to in §12. b) may be allowed to waive some of the protections afforded by the conduct of business rules subject to meeting two of the following size requirements<sup>(13)</sup>:
  - balance sheet total : EUR 12.500.000,
  - net turnover : EUR 25.000.000,
  - average number of employees during the financial year : 250.

## **b) Other investors**

- 14. The members of FESCO consider that investors other than those mentioned in § 10 and 12, including private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules.
- 15. Any such waiver of the protection afforded by the standard conduct of business regime shall be considered valid only if an adequate assessment of the expertise, experience and knowledge of the client, undertaken by the investment firm, gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved.

The fitness test applied to managers and directors of entities licensed under European Directives in the financial field could be regarded as an example of the assessment of expertise and knowledge.

In the case of small entities, the person subject to the above assessment should be the person authorised to carry out transactions on behalf of the entity.

- 16. In the course of the above assessment, as a minimum, two of the following criteria should be satisfied:
  - The investor has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
  - The size of the investor's financial instrument portfolio, defined as including cash deposits and financial instruments<sup>(14)</sup> exceeds 0,5 million Euro;
  - The investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

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<sup>(11)</sup> It should be noted that public sector bodies are subject to specific regulations that might prevent them from entering into certain types of transactions or opting for the professional conduct of business regime.

<sup>(12)</sup> Within the meaning of article 1.13 of the ISD.

<sup>(13)</sup> Criteria under article 27 of the Directive 78/660/EEC, on the Annual accounts of certain types of companies.

<sup>(14)</sup> Within the meaning of Section B of the Annex of the ISD.

## **II.2 Procedure**

17. The "*large and institutional investors*" defined above may waive some of the protections afforded by the conduct of business rules only after being informed in writing of the protections they will lose and stating in writing that they are aware of the consequences of losing such protections.
18. The "*other investors*" defined above may waive the benefit of the detailed rules of conduct only where the following procedure is followed:
  - a) they must state in writing to the investment firm that they wish to be treated as a professional investor, either generally or in respect of a particular investment service or transaction, or type of transaction or product;
  - b) the investment firm must give them a clear written warning of the protections and investor compensation rights they may lose;
  - c) they must state in writing, in a separate document from the contract, that they are aware of the consequences of losing such protections.
19. Before deciding to accept any request for waiver, investment firms must be required to take all reasonable steps to ensure that the client requesting to be treated as a professional investor meets the relevant requirements stated in Section II.1 above.

However, if investors have already been categorised as professionals under parameters and procedures similar to those above, it is not intended that their relationships with investment firms should be affected by any new rules adopted pursuant to this paper.

20. Firms must implement appropriate written internal policies and procedures to categorise investors.

Professional investors are responsible for keeping the firm informed about any change which could affect their current categorisation. Should the investment firm become aware however that the investor no longer fulfils the initial conditions which made him eligible for a professional treatment, the investment firm must take appropriate action.

- **Annexe 2: Matrix of applicable rules for professionals and non professionals**

## **Overview of applicability of the Principles and Rules for professionals**

### **1. PRINCIPLES AND RULES OF GENERAL APPLICATION**    **Applicable for professionals**

#### **1.1 GENERAL**

- **PRINCIPLES**

- |           |  |            |
|-----------|--|------------|
| <b>1.</b> |  | <b>yes</b> |
| <b>2.</b> |  | <b>yes</b> |
| <b>3.</b> |  | <b>yes</b> |

#### **1.2 CONFLICTS OF INTEREST**

- **PRINCIPLE**

- |           |  |            |
|-----------|--|------------|
| <b>4.</b> |  | <b>yes</b> |
|-----------|--|------------|

- **RULES**

#### **1.3 INDUCEMENTS**

- **PRINCIPLE**

- **RULES**

- 5.
- 6.
- 7.

#### **1.4 COMPLIANCE**

- **PRINCIPLES**

- |            |  |            |
|------------|--|------------|
| <b>8.</b>  |  | <b>yes</b> |
| <b>9.</b>  |  | <b>yes</b> |
| <b>10.</b> |  | <b>yes</b> |

- **RULES**

- |     |  |            |
|-----|--|------------|
| 11. |  | <b>yes</b> |
| 12. |  | <b>yes</b> |
| 13. |  | <b>yes</b> |
| 14. |  | <b>yes</b> |
| 15. |  | <b>yes</b> |

#### **1.5 CODE OF CONDUCT**

- **PRINCIPLE**

- |            |  |            |
|------------|--|------------|
| <b>16.</b> |  | <b>yes</b> |
|------------|--|------------|

- **RULE**

- |     |  |            |
|-----|--|------------|
| 17. |  | <b>yes</b> |
|-----|--|------------|





## **2. INFORMATION TO BE PROVIDED TO CUSTOMERS**

### **2.1) BASIC REQUIREMENTS**

- **PRINCIPLES**

18.

yes

19.

- **RULES**

20.

21.

22.

### **2.2) INFORMATION TO BE PROVIDED TO CUSTOMERS BEFORE THE PROVISION OF INVESTMENT SERVICES**

#### **2.2.1) MARKETING COMMUNICATIONS**

- **PRINCIPLES**

23.

24.

- **RULES**

25.

26.

27.

28.

#### **2.2.2) INFORMATION ABOUT THE INVESTMENT FIRM**

- **PRINCIPLES**

29.

30.

- **RULE**

31.

#### **2.2.3) INFORMATION ON FINANCIAL INSTRUMENTS AND INVESTMENT SERVICES**

- **PRINCIPLES**

32.

33.

- **RULES**

34.

35.

36.

37.

38.

39.

40.

41.

42.

43.

44.

47.

48.

49.



## **Derivatives and leveraged transactions**

50.

### **2.2.4 COMMISSIONS, CHARGES AND FEES**

#### **• PRINCIPLE**

**51.**

#### **• RULES**

52.

### **2.2.5 RISK WARNINGS**

#### **• PRINCIPLES**

**53.**

**54.**

#### **• RULES**

55.

56.

## **2. 3 CUSTOMER REPORTING**

#### **• PRINCIPLES**

**57.**

**58.**

**59.**

#### **• RULES**

##### **a) Confirmation of customer orders**

60.

61.

62.

##### **b) Contract Notes and trade confirmations**

63.

64.

65.

##### **c) Periodic information**

66.

## **Derivatives and leveraged transactions**

67.

## **3. THE KNOW-YOUR-CUSTOMER PRINCIPLE AND SUITABILITY**

### **3.1 INFORMATION FROM THE CUSTOMER**

#### **- PRINCIPLE**

**68.**

**yes, partly**

#### **- RULES**

69.

70.

71.

72.

73.

74.

75.

76.

77.



### **3.2 SUITABILITY OF THE SERVICE/PRODUCT FOR THE CUSTOMER**

#### **- *PRINCIPLES***

**78.**

**79.**

**80.**

#### **- *RULES***

81.

82.

### **3.3 EXECUTION-ONLY DEALING SERVICES**

#### **- *PRINCIPLES***

**83.**

**84.**

### **3.4 CUSTOMER REFUSAL TO PROVIDE INFORMATION**

#### **- *PRINCIPLE***

**85.**

#### **- *RULE***

**86.**

## **4. CUSTOMER AGREEMENTS**

### **4.1) BASIC CUSTOMER AGREEMENT**

#### **• *PRINCIPLES***

**87.**

**88.**

#### **• *RULES***

89.

90.

91.

92.

93.

94.

### **4.1) CUSTOMER AGREEMENT INVOLVING TRADING IN DERIVATIVES**

#### **• *PRINCIPLE***

**95.**

#### **• *RULES***

96.

97.

98.

99.

100.

## **5.- DEALING REQUIREMENTS**

- **PRINCIPLES**

**101.** **yes<sup>(15)</sup>**  
**102.** **yes**

### **5.1) RECEPTION AND TRANSMISSION OF CUSTOMER ORDERS**

- **PRINCIPLES**

**103.** **yes**  
**104.** **yes**  
**105.** **yes**  
**106.** **yes**

- **RULES**

- **Reception**

107. **yes**  
108. **yes**  
109. **yes**  
110. **yes**

- **Transmission**

111. **yes**  
112. **yes**  
113.

### **5.2) EXECUTION OF ORDERS**

- **PRINCIPLES**

**114.** **yes**  
**115.** **yes**  
**116.** **yes**

- **RULES**

117. **yes**  
118.  
119.  
120.

### **5.3) POST- EXECUTION OF ORDERS**

- **PRINCIPLES**

**121.** **yes**  
**122.** **yes**

- **RULES**

123. **yes**  
124. **yes**  
125.  
126.  
127.  
128.

---

<sup>(15)</sup> The professional can be a professional customer or a counterparty. The Principles and Rules 101 – 116 and 121 – 124 apply to professional customer's. The Principles and Rules 106 – 109 also apply to a counterparty (the wording is slightly adapted to the principal situation). Rule 117 applies to the counterparty/principal trading as well.



## **6. DISCRETIONARY PORTFOLIO MANAGEMENT**

### **6.1 CUSTOMER AGREEMENTS FOR DISCRETIONARY PORTFOLIO MANAGEMENT**

#### ***- PRINCIPLES***

**129.**

**yes**

**130.**

#### ***- RULES***

131.

132.

133.

134.

135.

136.

137.

#### **Delegation of portfolio management**

138.

**yes**

139.

### **6.3 PERIODIC INFORMATION**

#### ***- PRINCIPLES***

**140.**

**141.**

#### ***- RULES***

142.

143.

144.

145.

146.

147.

### **6.4 MANAGEMENT REQUIREMENTS**

#### ***- PRINCIPLES***

**155.**

**156.**

**157.**

**158.**

#### ***- RULES***

159.

160.

161.