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The Committee of European Securities Regulators
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Dear Sirs

Consultation Paper on CESR Technical Advice to the European Commission in the context of the MiFID Review – Client Categorisation

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee. Members of the CLLS Regulatory Committee (the "**Committee**") advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are grateful for the opportunity to respond to the Consultation Paper and for your agreement to extend the deadline to accommodate our response.

Part 1: Technical Criteria to further distinguish within the current broad categories of clients "other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I (1)(c), (h) and (i) of MiFID)

1 ***Do you agree that the opening sentence of Annex II,I(1) sets the scope of this provision and that points (a) to (i) are just examples of "Entities which are required to be authorised or regulated to operate in financial markets"?***

We find the drafting of Annex II.I(1) less than clear, particularly since a number of the types of entity listed in points (a) to (i), are frequently not authorised or regulated and are certainly not

required by EU wide law to be so authorised or regulated. Examples are (i) other institutional investors, many collective investment undertakings and their managers (even after the Alternative Investment Managers Directive is finalised the collective investment undertakings will not themselves be authorised although they will be indirectly regulated through their managers) and some pension funds and their managers.

Moreover, some of those which are authorised are not, strictly speaking, authorised or regulated "to operate in financial markets" as opposed to being authorised or subject to regulation in the general conduct of their business or aspects of their business. Examples would again include a number of collective investment undertakings and pension funds and some of their managers.

And finally the language used, if applied to restrict the descriptions in points (a) to (i) as the Consultation Paper indicates, has the curious result that financial institutions from non-EU Member States which do not impose authorisation or regulation on the relevant activity cannot fall into Annex II.I(1) and therefore would potentially receive a higher level of protection than an identical firm from the EU. There does not seem to be a policy justification for this and we suggest that it would be more appropriate to refer in the chapeau to those which would require authorisation or regulation if they were located in the EU or, in other words, state that the list includes not only those who are in fact authorised or regulated by a non-Member State but also those who carry out the relevant characteristic activities without being subject to local regulation or authorisation requirements in their home state.

Each of these points might suggest that the list in (a) to (i) should not be wholly circumscribed by the chapeau relating to authorisation or regulation. Nevertheless we agree that, although it is not entirely clear and the policy ground for the restriction is obscure, the better reading of Annex II.I(1) is that the chapeau sets the scope of the provision and the list is just a list of examples.

2 ***Do you think there is a case for narrowing the range of entities covered by points (c), (h) and (i) of Annex II.I(1)? Please give reasons for your response.***

It is important to note that the category of "per se professional" set out in Annex II.I(1) is not compulsory. It is open to any organisation falling within the category to request treatment as a retail client instead and we are aware of cases where such a request is made and granted. It could do this either because it was concerned that it did not have the knowledge and experience necessary (generally or in respect of specific types of investment) or if for any other reason it wishes to have retail client protections. This appears to us to be the correct balance of protection for such organisations.

We do not believe that there is a case for narrowing the range of entities covered by points (c), (h) and (i). On the assumption that these headings are already limited to institutions which are in some way authorised or regulated to operate in the financial markets that is a very serious restriction already. It seems to us inappropriate for one regulated financial sector institution to be second guessing the expertise of another regulated financial sector institution in terms of its fitness to be classified as a "per se professional".

Indeed, as noted above, we believe there is a case for somewhat widening the range so that entities which would be required to be authorised or regulated if operating in the EU should fall within the scope even if they are not in fact subject to authorisation or regulation in their home country. This would ensure a uniform treatment of non-EU firms engaged in the same activity as EU firms, rather than giving them retail status just because their home jurisdiction has a different regulatory structure and requirements to that applicable in the EU.

We should also add, as a general point, that the quantitative criteria for "opting up" to professional status are so poorly adapted to some types of investment activity that it cannot be assumed that all such undertakings would be capable of being "opted up" to professional status under Annex II.II, even when they are clearly highly expert in the relevant sector. We comment

further on this below since although it was not a question directly raised by the Commission with CESR it does affect each of the questions which were raised.

3 ***If you believe there is a case for narrowing the range of entities covered by points (c), (h) and (i) of Annex II.I(1) what criteria do you think should be used to distinguish between those entities that are covered and those that are not?***

Since we do not believe that there is a case for narrowing the range of entities covered we do not think there is a need for such criteria.

However we comment on the three suggestions made:

(a) *"equivalent" regulation.*

Establishing the "equivalence" or otherwise of different regulatory systems is notoriously difficult even when the equivalence concerned relates to very specific areas and types of institution. It would require a major effort and resource from the EU and/or competent authorities/investment firms to undertake such a review across the whole financial sector and it is not clear to us what value it would in fact bring to the assessment of the professionalism or otherwise of different organisations. As noted above in jurisdictions where a particular activity normally regulated in the EU is not locally regulated that does not prevent an organisation carrying on that activity being extremely expert and professional in any normal understanding of the term. An example of particular significance is that until implementation of the Dodd Franks Act US investment managers with fewer than 15 clients (each of which may be a very large fund with billions under management) do not require registration under the Investment Advisers Act.

(b) acting for underlying clients

We are not sure of the rationale for this proposal and if it is envisaged that acting for underlying clients would automatically bring the firm concerned into the category, on the basis that it is providing a professional service. If so we cannot see why those investing on their own account should be excluded.

(c) *size of entity in the case of (c) (other financial institution) and (i) (other institutional investor)*

When it comes to professional investors we do not believe size is necessarily a criterion for expertise and professionalism. This is particularly the case for advisory and highly specialised firms. Moreover the normal type of size tests, of the kind given in Annex II.I(2), which apply to all types of undertaking are not particularly appropriate to apply to financial institutions and institutional investors because:

- Balance sheet total, although it may be relevant for an own account investor, is less so for an adviser or manager of others assets;
- Turnover is more relevant for trading than investment; and
- Own funds again is less relevant for those which are not investing on their own account.

Similarly size tests relating to the number of employees of an organisation, which are imposed in some other circumstances, are not relevant for expertise in the financial sector. A very small advisory or management entity may be highly expert.

It was our understanding that it was a recognition of the inappropriateness of normal size tests assessing specialist financial sector organisations, including financial institutions and other institutional investors, which was the reason for separate identification of the specialist categories in Annex II.I(1)(3) and (4). We do not think it would be constructive to impose such tests now.

We should also note that when size tests are applied it would be much better to apply them on a group basis. It is very common that a small entity within a large group is used by the group to manage, for instance, treasury functions or otherwise carry on an aspect of group business involving financial instruments and it should be possible for account to be taken of the size of the group when classifying group members.

4 ***Do you believe there is a need to clarify the language in points (c), (h) and (i) of Annex II.I(1) and, if you do, how do you think the language should be clarified?***

Although we agree that the wording of these points is not particularly clear we are not aware of any practical difficulties or regulatory problems which have arisen in their interpretation such that it is essential to provide further clarification. More specifically:

(a) The purpose of the definition of a "financial institution" in the BCD and CRD is very different from the purpose of the term in MiFID. Although it is probably true that the BCD/CRD definition is a fair starting point for thinking about what the term means we do not believe it is necessary or appropriate simply to cross refer to it. Moreover the BCD/CRD definition itself can be difficult to interpret and we do not believe that it would help to clarify the term in MiFID.

(b) We agree that our understanding of the term "locals" is essentially those described in Article 2(1)(l) MiFID and we agree it may be helpful to make the cross reference to that exemption since the term "locals" may not be as well understood now as it was in the past.

(c) We think that "other institutional investors" is meant to cover institutional investors not covered under any of the preceding points (thus impliedly involving a broad definition of investors which encompasses both own account investors and those acting for or advising them). We do not agree that in this paragraph there need, or should, be a limitation or focus on investing in financial instruments.

If there is the appropriate authorisation or regulation (or equivalence of activities outside the EU if the section is broadened as we recommend) this should be sufficient even if the main focus of the relevant organisation was, for instance, investment in real property or commodities with investment in securities or derivatives being a related activity. Institutional investors whose main activity is to invest in financial instruments are covered by Annex II.I(4) and there would be no point in restricting paragraph (i) of Annex II.I(1) so that it was merely a subset of (4). It would be helpful to make it clear that, as noted above, institutional investors includes institutions investing as agent.

Part 2: Public debt bodies

5 ***Do you think that Annex II.I(3) should be clarified to make clear that public bodies that manage public debt do not include local authorities?***

No comment. The powers and competence of different local and regional authorities and the arrangements made for managing public debt can vary extensively from state to state.

Part 3: Other client categorisation issues

6 ***Do you believe that it is appropriate that investment firms should be required to assess the knowledge and experience of at least some entities who currently are considered to be per se professionals or to other categories of clients who are currently considered to be professionals?***

We do not believe this is necessary for the purposes of client classification. It is important to bear in mind that:

(a) the "per se" professional classification is not really a confirmation that the relevant institution has the necessary knowledge and experience, but rather that it is reasonable to presume that it does so unless it notifies the investment firm that it does not and that it wishes to be given non-professional treatment. There are provisions to ensure that the client is fully informed of its rights to request a different classification.

(b) The client organisation is thus only required to have sufficient resources to consider whether it does have sufficient knowledge and experience to be treated as a professional in relation to the relevant services and without the benefit of additional protections and to request additional protection if it is uncertain. It does not appear to us that any of the currently listed types of per se professional should lack that degree of competence such that the presumption of expertise should run the other way and the whole assessment burden should be placed on the investment firm.

(c) Investment firms still have extensive duties to their professional clients, including:

- Acting honestly, fairly and professionally in the best interests of the client
- Providing fair, clear and not misleading information
- Providing appropriate information so that the client concerned is reasonably able to understand the nature and risks of the investment service and of the particular type of financial instrument being offered.
- Preventing conflicts of interest adversely affecting clients' interests
- Obtaining or requesting the necessary information about the client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and investment objectives to enable the firm to fulfil its suitability/appropriateness obligations.

The last of these duties is qualified somewhat by the provisions in the MiFID Implementing Directive allowing investment firms to assume that a professional client has the necessary level of experience and knowledge (though information about investment objectives and, except for firms falling within Annex II.I(1), financial situation, must still be sought).

It appears to us that proper compliance with these duties could have prevented the practices referred to in paragraph 32 of CESR's consultation paper without the need for a change in the structure of client classification.

(d) We do not know whether some "per se professionals" are overestimating their knowledge and experience and failing to seek additional protection which they need.

(e) If there is a concern that more protection may be needed in some circumstances this could be dealt with more appropriately in conduct of business rules addressing any specific concerns than by the relatively crude approach of narrowing the boundaries of those who are classified as per se professional clients and thereby potentially turning them all into retail clients. As noted in more detail under Additional Comments below, it is not the case that all

those with the appropriate knowledge and experience could opt up to elective professional client status.

7 ***Should a knowledge and experience test be applied to large undertakings before they can be considered to be per se professionals or to other categories of clients who are currently considered to be professionals?***

As noted above we do not think that such a test is necessary and consider that, if any additional protection is thought necessary as a policy matter it should be provided by an adjustment to the conduct of business rules rather than a narrowing of the client classification boundaries.

This is particularly important because, as CESR has highlighted in its paper, large undertakings, and indeed others carrying on complex business, can need access to complex tailored instruments in order to hedge their risks and exposures.

We also note that sometimes large institutions, such as energy companies, requiring complex tailored instruments in order to hedge their risks and exposures will have a much more detailed and sophisticated understanding of the underlying market to which the derivative is to relate than will the investment firm with which they deal.

As noted under "Additional Comments" below the "opt up" professional client process is not well adapted for such instruments. Moreover the application of the "large undertaking" tests on an individual undertaking, rather than a group, basis produces illogical and unfortunate results.

8 ***Do you believe that the client categorisation rules need to be changed in relation to OTC derivatives and other complex products?***

It is our understanding from CESR's paper that its principal concern in this context is Eligible Counterparty (ECP) business in relation to which suitability and the other duties we refer to above do not apply. We agree that classification as an ECP potentially has much more important consequences than professional client classification and this needs careful consideration.

We note, however, that, as CESR highlights, in many situations the business done is not in fact ECP business so that professional client status applies in any event. Moreover even when the business concerned is ECP business:

(a) the organisation concerned is still entitled to request either generally or on a trade by trade basis, the protections given to professional clients. In our experience such requests are frequently made and granted (for instance in the case of investment managers dealing with brokers);

(b) express confirmation of agreement to be treated as an ECP is required in the case of those classified as ECPs by reason of their size or similar matters.

We are inclined to think that these continue to be the appropriate protections, even when the financial instruments concerned are highly complex. We also note that it would not be straightforward to define what is meant by a "highly complex" financial instrument.

9 ***If you believe the rules should be changed:***

a. For what products should they be changed; and

b. Which of the approaches to change set out in the paper would you favour?

We do not consider that a change is needed since the types of organisation concerned should be capable of requesting non-ECP treatment whenever they think it necessary.

If a change was to be made we think the better approach would probably be a combination of the second and third approaches, limited to a fairly tightly defined class of highly complex securities (not all asset backed or non-standard OTC derivatives are necessarily highly complex), under which for such transactions there are certain classes of "per se" super ECPs and then other normal ECPs are subject to an opt up process involving both:

(i) their request/confirmation that they wish to be treated as an ECP for such highly complex transactions and believe themselves to have the relevant expertise etc to enter into such transactions without relying on the firm to act for them; and

(ii) an assessment by the firm of whether it has reasonable grounds for believing that the organisation in question does indeed have such expertise.

However we think that the existing power to request non-ECP treatment is a sufficient protection and such a change is unlikely to provide useful further protection, as opposed to merely additional paperwork.

10 Do you believe it is necessary to clarify the standards that apply when an investment firm undertakes a transaction with an ECP?

We do not. The concept of an ECP is that market professionals are dealing with one another directly and each is responsible for protecting its own interests.

11 If you believe a clarification of these standards is necessary do you agree with the suggestions made in this paper?

We believe that the principles of market integrity are the appropriate standards and that these are duties owed to the market as a whole rather than just to the counterparty. It is correct to address these as a matter for regulation by competent authorities under Article 25 without necessarily adding a separate direct obligation to the counterparty. We believe it would be potentially confusing, and contrary to the ECP concept, to phrase these as duties owed to the counterparty in a way similar to the duties owed to professional clients.

ADDITIONAL COMMENTS – CLIENT CATEGORISATION NEEDS AN IMPROVED "OPT UP" PROCESS IF IT IS TO WORK PROPERLY ACROSS ALL RELEVANT MARKETS

Real difficulties have been caused to firms and their clients by the operation of the "opt up" provisions in Annex II.II in markets other than the public equity markets.

It is therefore unfortunate that the matters referred to CESR have not yet included the operation of the Annex II.II process. This is particularly the case since it seems that an increasing number of other Directives (e.g. the Prospectus Directive and, much more problematically, the proposed Alternative Investment Fund Managers Directive) are adopting the MiFID definition of "professional investor". We are in favour of creating consistency between the classifications used under different directives, such as the Prospectus Directive, compensation scheme eligibility and MiFID, but it cannot be assumed that all of such other Directives have the "financial instrument" focus of MiFID .

We thought it appropriate to comment briefly on these opt up provisions because underlying any reassessment of the "per se" professional categorisation there tends to be an assumption that there is an appropriately calibrated mechanism by which others who have the necessary knowledge and experience can be classified as professionals in the market in which they are expert, if they wish to be so classified.

Any such assumption is incorrect.

We are strongly in favour of the qualitative assessment which investment firms must make under the first half of Annex II.II (1) of whether the expertise, experience and knowledge of the client 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. We note that this obligation places a very heavy responsibility on the investment firm.

However, in relation to many sectors the "minimum" required of also satisfying two out of three specific quantitative criteria is not appropriate for the transactions and services envisaged. This is because the criteria were, we believe, originally established having in mind a moderately competent regular trader in the public equity markets. In relation to other asset classes, which still involve financial instruments, such as investment funds, private equity and certain types of derivative, the criteria are much less appropriate and disqualify some of the most experienced and able investors.

Taking each criterion in turn:

(a) the requirement for carrying out frequent transactions on a quarterly basis is simply not appropriate for long term asset types which are bought in order to be held, either for long term rather than speculative investment or for hedging purposes, not in order to be traded. Imposing a trading or rapid turnover obligation to prove professionalism in fact risks qualifying as professional those who churn their investments inappropriately and disqualifying those who invest prudently. Specifically in relation to private equity/venture capital the due diligence and negotiation in relation to each transaction makes it next to impossible for even the most active investor in the sector to make as many as 10 investments in a quarter. A private equity/venture capital investment fund active in the sector would be more likely to do three to five transactions in the course of a year.

Similar comments can be made in relation to other types of investment, particularly when financial instruments relate to other types of underlying asset class, such as real property, but investments are made in funds which invest in the asset class and/or in derivatives which hedge against risk in the asset class. An investor which is highly experienced in the sector and in relation to the relevant types of instrument would not necessarily be dealing frequently.

The test is also unworkable in the area of corporate finance where it is simply not the case that anyone does a large number of transactions. If the relevant person happens also to be a regular trader in the secondary markets it may technically qualify under this head but in fact such trading is irrelevant to the question of expertise in the primary markets,

Accordingly in relation to a substantial range of different types of investment and transaction type the inappropriateness of this criterion effectively means that an investor active and experienced in the area cannot satisfy this requirement and must instead satisfy both the other requirements on a mandatory basis.

(b) The requirement for a portfolio of cash and financial instruments of at least €500,000 is not generally a problem in itself. However there are occasions when an individual or firm does not have an investment portfolio of this kind, either because he/it has not yet had the opportunity to build up the portfolio or because assets are held in other forms or used in the relevant person's business. This was always envisaged as a possibility and it was not intended to make wealth of this kind mandatory for a professional qualification provided appropriate experience was there (hence the "two out of three" requirement). Indeed wealth of this kind is not a particular guarantee of knowledge or experience and rarely adds anything useful to the qualitative assessment the investment firm has to undertake. It does, however, act as a disqualification factor given the way in which the other two criteria work.

(c) The requirement for a year's professional experience in the financial sector in a position requiring experience of the relevant transactions and services, although a perfectly reasonable indicator of experience, cannot be applied to anyone working outside the financial sector, no matter how much longer than a year's experience they have of the relevant transactions and services. Accordingly they must instead satisfy both of the other requirements on a mandatory basis. As noted above it is often not possible to do so and in particular the frequent dealing test is positively inappropriate for many sectors and types of financial instrument.

In our view these quantitative tests add so little of value to the serious qualitative assessment obligations imposed on firms who agree to "opt up" clients that they could reasonably be deleted altogether. If that is not thought appropriate we strongly recommend that the tests are amended to apply on a "one out of three" basis or to have a number of other criteria added, including criteria which relate to the underlying asset class to which the financial instrument relates, from which a selection appropriate for the relevant business may be made. If the quantitative tests are deleted or modified to involve a higher element of judgment of expertise by the firm consideration might be given to adding a requirement for the firm to share with the client the reasons for its assessment of knowledge and experience, as well as giving the necessary warnings and information on client status, so that when deciding whether to confirm its opt up the client can also object to the firm's reasoning or point out errors in the material the firm is relying on.

We would be delighted to discuss the above observations and suggestions with you. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Chamberlain
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