

CESR'S CONSULTATION ON CLIENT CATEGORISATION (CESR/10-831)

Response of the AMAFI

1. **The Association française des marchés financiers (AMAFI)** has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

2. AMAFI welcomes the opportunity provided by CESR to answer its consultation on client categorisation. In the present document, AMAFI wishes to make the general observations set out below (I) and provides some specific answers to the questions raised by CESR (II).

I. – General Observations

3. As a preamble, AMAFI regrets that the time allowed to respond to the consultation – in particular during the summer break period - was not set at the three-month standard applicable to significant issues (see CESR's public statement of consultation practices consultation policy – CESR/01-007c). This is especially so since many consultations are on-going at EU level but also at national level and the issue at stake here is of particular importance to firms, due to the impact any change in client categorisation rules would have on firms' organisations and client relationships.

The principles that drive categorisation in MiFID are still valid and should not be altered

4. The client categorisation rules, as CESR reminds us in § 28 of its consultation paper, is aimed at tailoring client protection to clients' ability to make their own investment decisions and understand the risks involved. CESR considers however that these rules lead to too broad professional categories in which some investors have been classified without possessing the corresponding knowledge and experience.

AMAFI believes however that, in general, the client categorisation rules provide appropriate level of protection to the three categories of clients: retail, professionals and eligible counterparties (ECPs).

5. It is true that per se professional clients is a broad category that includes different entities but, in accordance with the definition, they all are deemed to possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur (Level I Directive, Annex II, first paragraph). This definition does not mean that professional clients know everything in the financial markets but only that they, and even more so ECPs, have a certain level of experience and knowledge. At the very least, professional clients are expected to know when their experience and knowledge are insufficient: “*professional clients should, subject to limited exceptions, be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the investment firm to provide that information*” (Level II Directive, Recital 44). This capacity is the essence of the definition of professional clients in MiFID and cannot be altered without changing the philosophy of the client categorization rules. This observation underlies AMAFI’s position in the rest of the document on whether more tests should be performed by investment firms on their professional clients: to be consistent with the definition of professional clients, there is no basis to transfer on investment firms their clients’ responsibility to know when they don’t know.

6. In addition, MiFID already provides some safeguards against incorrect per se categorization, as when a professional client judges that its knowledge is insufficient, he or she always has the possibility to opt down for a more protective category (Level II Directive, article 28). This is a very important safety feature embedded in the Directive that should not be forgotten in designing changes to the categorization rules.

This means that a categorisation is never definitive and a client, under MiFID, can always benefit from a higher level of protection if he chooses so.

Entities listed as per se professionals must truly be professionals

7. It follows from the above that, to safeguard the essence of professional clients, it is better to have a list of per se professionals that is clear and undisputable, rather than create sub-categories within it that would require the implementation of multi-dimensional procedures, which present a high risk of confusion both from the point of view of an investment firm’s staff and clients and are likely to result in unintentional regulatory breaches and clients’ complaints.

In our opinion, an alternative solution consists in ensuring that the list of per se professional clients and ECPs truly corresponds to entities that have the necessary knowledge and experience to make their own investment decisions and understand the risks involved. These lists should be sufficiently precise to leave no room to interpretation.

II. – Questions

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)]

Q 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.”?

8. AMAFI shares CESR's analysis that points (a) to (i) are examples of entities which are required to be authorised or regulated to operate in the financial markets.

Q 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.

9. It is indeed not clear what the categories covered by points (c), (h) and (i) are covering and this raises questions.

- Other authorised or regulated financial institutions

10. The scope of Annex II.I. (1) of the Directive contains, as stated in the chapeau, entities authorised or regulated by a Member State and or by a non Member State, of which credit institutions and investment firms are considered in points (a) and (b) and asset managers in point (e). It is not clear therefore which financial institutions this category is aiming at. One possibility could be that it targets regulated entities whose status is specific to a Member States (like “conseillers en investissements financiers” in France). If it is so, AMAFI is of the opinion that, to clarify this point, each Member State should communicate to the European commission (or ESMA) which entities it includes in this category.

- Locals

11. The definition proposed by CESR does correspond to the transposition that France has made of this point¹. However one can wonder why these entities are called “locals” as there is no geographical concept attached to this definition. Some further clarification in this respect is needed.

- Other institutional investors

12. Finally, AMAFI believes that amore precise definition of (i) “other institutional investors” could be provided by adding that their main activities which are to invest in financial instruments result from a regulatory obligation or their legal status.

Q 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?

13. These three points are not used extensively by firms to categorise their professional clients. The issue here is more theoretical (in terms of clarifying their definition as proposed by CESR) and it does not

¹ Code monétaire et financier, art. D. 533-11 1. h) and art. L. 531-2 2° n).

seem that complaints/issues occurred in practice with these three points as far as mis-classification is concerned. AMAFI therefore does not think that there is a case for narrowing the range of these three points.

14. Having said that, if the criterion of the equivalence of a jurisdiction is kept then it is critical that the list of such jurisdictions be provided.

As for the criterion regarding whether the entity conducts business on behalf of underlying clients or not, it is not adequate, as this has no impact on whether an entity has proper knowledge and expertise (the protection – and knowledge - of the underlying clients being a separate issue).

As to the third proposed criterion, the size of the entity, this is in AMAFI's view not acceptable (see our general observation § 4) as these entities covered by points (c) and (i) are regulated or authorized and have therefore been judged by regulators "true" professionals irrespective of their size, i.e. they should at least have enough knowledge and expertise to know when they do not know something and request more information or an opt-out to a safer category. If not, one can have doubt as to the appropriateness of the authorization they have been given or as to the quality of the supervision applied to them.

Q 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?

15. See answer to question 2.

Part 2: Public debt bodies

Q 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?

16. As local authorities (i.e. municipalities and other local authorities) can manage public debt, they could indeed be classified as per se professional clients, whereas they do not always have the necessary level of knowledge and experience. AMAFI therefore agrees with CESR's proposal.

17. More generally, it would be useful to have a clear definition of what is a local authority, as this may encompass very different entities depending on the Member States. Without it, this category of entities will always trigger ambiguity as to its interpretation.

Part 3: Other client categorisation issues

Q 6: Do you believe 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 under MiFID?

18. AMAFI does not believe it is appropriate because such proposal denies the principle underlying MiFID client categorisation rules (see our general observation § 4). Testing professional clients would render meaningless the list of per se professional clients.

As stated before, there should be no doubt that entities listed as per se professionals are truly professionals, which anyway is not irreversible as any such client can change category in general or for a particular transaction if he or she wishes so.

19. In addition, testing professional clients for knowledge and expertise raises practical issues: if one could argue that an entity's expertise could be tested looking at its past transactions, what about its knowledge? Should the test be performed on individual(s), and if so on whom? If so, would the test be valid for the entity or would it be attached to the individual himself (with the resulting issues linked to staff turnover, etc.)? Such a testing process would be very onerous for firms for little benefit considering that as for now, it does not seem that there have been major issues of client's misclassification (further information from CESR on actual failings of the current regime are welcome). It is also likely that the administrative process involved will irritate clients who are already classified and complained of the administrative side of MiFID when it was implemented and/or consider themselves as seasoned investors.

20. In our opinion, a more effective solution would be to limit the list of per se professional clients to those for whom there is no doubt that they have the necessary experience and knowledge. As entities who are authorized or regulated should naturally meet this requirement, as well as national and regional governments (point I. 1. (3) of annex II) and other institutional investors (point I. 1. (4) of annex II), CESR's concern most certainly lies with large undertakings (point I. 1. (2) of annex II). One way to ensure these actually meet the knowledge and expertise required to qualify as professional clients could be to raise the current criteria of size to ensure only truly large undertakings are within scope.

Q 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?

21. AMAFI does not think so - see its answer to question 6.

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

22. AMAFI does not think that the client categorisation rules should be changed in relation to OTC derivatives and other complex products and, more generally, it does not think that client categorisation should be based on products.

This would create different types of eligible counterparties and professional clients depending on the underlying products, requiring different approaches. From an organizational point of view, it would be extremely difficult to handle this complexity properly, requiring sales staff, for a same client, to provide different information depending on the product/client category concerned.

Similarly, clients would have to understand that they are not classified the same depending on the product concerned. For example, when the implementation of MiFID has resulted in classifying some clients in different categories depending on the financial instruments concerned, several firms reported that it has proved difficult for their clients to understand this dual categorisation and that it has created a negative perception of their firm's assessment process. As already mentioned, investment firms should be able to draw up procedures that are understandable and workable for their staff and their clients, something that this proposal will render very difficult to achieve, increasing firms' regulatory risk.

23. More specifically, and putting this issue aside that applies across the board, the four ideas proposed by CESR raise the following additional comments.

- 1st idea: no ECP status available for transactions in highly complex products

24. Apart from the fact that eligible counterparties, by nature, should know when they are lacking information or when they need protection, another issue created by this approach is that it assumes that the concept of "highly complex products" be defined, which will be extremely difficult to do.

Indeed, the same product often has different risk profiles depending on the circumstances in which it is used making it almost impossible to create a generic list of very complex (or risky) products adapted to any client. Also, there is no obvious connection between the ideas of "complex" and "risky": the complexity of a product is often not linked to its risk profile and many complex products are designed specifically to reduce risk.

25. AMAFI therefore sees great danger in the perverse effect this proposal could have on the availability of tailored products to sophisticated clients.

- 2nd idea: a super ECP status for highly complex products

26. This approach has the advantage of acknowledging that some eligible counterparties are indeed sophisticated and able to deal in highly complex products. But it is also subject to criticism for the same reasons as explained above.

- 3rd idea: undertakings would need to make a request to be considered as ECPs and firms would have to consider their expertise, experience and knowledge in highly complex products

27. Please see AMAFI's comment in § 19 that is also applicable here, in addition to the comments made above for the other ideas.

- 4th idea: firms that know or have reason to know that an investor classified as an ECP is unlikely to be able to properly assess the risks of a particular instrument or transaction should treat that investor as a professional client for the relevant transaction

28. This approach is not acceptable because the responsibilities of the professional (the ECP) are transferred the firm. Please see our comment in § 5 on this subject.

In addition, it rests on very subjective notions and would be tricky to implement, commercially speaking, as it would require the firm to explain its client that it is not as sophisticated as it may think.

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

- **For what products should they be changed; and**
- **Which of the approaches to change set out in the paper would you favour?**

29. See answer to question 8.

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

30. AMAFI obviously supports the principle that firms should act with honesty in their commercial dealings but the proposal raises questions. As CESR admits (see § 37 of the consultation paper), it makes sense that investment firms are not under an obligation to act in accordance with the best interests of the client when dealing with ECPs because they are deemed to be able to look after their own interests.

31. CESR believes that it is necessary though to make it explicit, via new provisions in MiFID, that in dealings with ECPs, investment firms have to act honestly, fairly and professionally. But article 25 of MiFID already sets up this standard, irrespective of the category of clients concerned, with the objective to promote the integrity of the market: *“Member States shall ensure that appropriate measures are in place to enable the competent authority to monitor the activities of investment firms to ensure that they act honestly, fairly and professionally and in a manner which promotes the integrity of the market”*.

In § 39 of the consultation paper, CESR admits that this provision is not limited to retail and professional clients. And article 24 of MiFID related to transactions with ECPs does not exclude this provision. So, investment firms already have the obligation to act honestly, fairly and professionally and in a manner which promotes the integrity of the market, whatever the type of client they are dealing with, including ECPs². AMAFI therefore believes that it is unnecessary to add this specific obligation on firms in relation to dealings with ECPs.

If this proposal was to fill a gap (which one?), CESR would need to provide more information so that one can appreciate the consequences this would have on firms compared to the existing obligation, i.e. several questions would need to be answered :

- Is the change aiming at some misbehaviors that cannot be caught today and if so which ones?
- What new obligations on firms would this trigger?
- What would it change in terms of differences between ECPs and other clients?

32. Regarding CESR's proposal to make clear that investment firms should communicate with ECPs in a way that is fair, clear and not misleading, here again, AMAFI believes it is unnecessary because it is already included in the general principle set in article 25 of MiFID.

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

33. See answer to question 10.



² For example, France has transposed this provision as one that is applicable to all categories of clients: *“investment service providers are required to act honestly, fairly and professionally and in a manner which promotes the integrity of the market”* (*Code monétaire et financier, article L. 533-1*)