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Response to CESR consultation on client categorisation

Key Points

The EBF considers that there are no grounds that may justify a revision of client categorisation rules. Furthermore, the current categorisation regime is flexible enough to cater for different advice/selling situations, considering both the type of investors and their relation with specific investment products (i.e. OTC derivatives and other “complex” products).

The clarification of existing sub-categories of professional investors is neither a client nor an industry demand. Any regulatory-driven clarification should not amount to a narrowing of the range of entities included in the category “professional investor”.

Local authorities that concretely manage public debt should be treated as *per se* professional clients. The establishment of a definition of what constitutes a “local authority” in the context of MiFID would be useful.

As it is the responsibility of the client to ask for a higher level of protection when it deems it is unable to properly assess or manage the risk involved, investment firms should not apply knowledge and experience test to clients.

Contact Person: Enrique Velázquez, e.velazquez@ebf-fbe.eu and Uta Wassmuth, u.wassmuth@ebf-fbe.eu Related documents: MiFID Review 2010: EBF Views on Areas to be addressed and on Priorities
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General remarks

The EBF considers that CESR's approach to the questions on client categorisation should take stock of the following four considerations:

- Banking and investment management are businesses that heavily rely on mutual confidence and, consequently, it is in the interest of the sell-side to treat clients fairly, honestly and in a non-misleading way, irrespective of client categorisation rules.
- The sell-side is of the opinion that the current MiFID client categorisation regime is working fine. Evidence of alleged mis-selling of certain products to certain *per se* professional investors is, broadly speaking, very limited and should be measured against the background of all transactions. The EBF would welcome the publication of statistical data by CESR on this topic to more robustly underpin ongoing policy discussions.
- The current categorisation regime - that has been introduced at high cost by the industry - is flexible enough to cater for different advice / selling situations. The regime (article 28 of the level 2 Directive) allows firms to take into account the specific needs / requests of different clients: where clients do not feel comfortable with particular products, they may opt for treatment as retail clients. This choice is product-by-product.
- The experience of the relationship between investment services providers and their institutional clients has proved, not only since the implementation of the MiFID, that these clients are not willing to excessively formalise this relationship and that, in such context, it would be detrimental to add new written procedures to process-intensive MiFID.

In the absence of market failure and against the background of a principle-based regime that allows for a customised treatment of different advice / selling situations and the accumulated experience with this regime so far, the EBF considers that there are no grounds that may justify a revision of client categorisation rules. Categorisation is part of a larger system of investor protection, consisting also of suitability and appropriate tests for certain services, information rules and fitness and properness tests for prospective directors. Any change in the categorisation rules should be seen in this context and the EBF considers that, generally speaking, the present system works. Firms have received very few client complaints relating to this specific issue.

The EBF, nonetheless, welcomes CESR's consultation and takes the opportunity to pass on some more detailed remarks in the below section.

The EBF notes that gathering the views of national banks associations and market practitioners in the summer break (July-August) proves challenging and would kindly request CESR to restrict its consultations to the minimum possible during those two months.

Responses to the European Commission's specific questions

A. Technical criteria to further distinguish within the current broad categories of clients

(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."?

Yes.

(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.

No. Reasons:

- The case for narrowing the range of entities covered in the sub-divisions of *per se* professional clients would be there if those entities were caught in non-flexible, closed sub-categories. However, Annex I.I of MiFID and article 28 of the level 2 Directive contain provisions allowing any *per se* professional client to opt to be treated as a retail client.
- Furthermore, narrowing the range of entities covered by points (c), (h) and (i) would amount to exempting an undetermined number of authorised entities from the category of *per se* professional clients. Accepting such exemption may tacitly imply that those regulated entities would *de facto* lack the knowledge and expertise to make their own investments decisions and properly assess the risk they incur. The EBF considers that such an exemption may call into question the fitness and properness assessment (e.g. integrity, skills and experience) of directors and senior management that is customarily carried out in assessing applications for financial entities' authorisation in the first place. Having passed the fitness and properness assessment, these directors should be deemed professional enough to gauge whether or not they understand a product.
- Regarding point (c), CESR appears to be proposing to exempt entities outside the European Economic Area (EEA) from being considered *per se* professional clients. That would imply an unjustified unlevel playing field against European entities as they would be obliged to treat foreign entities as retail clients in all cases. However, those entities are likely to have enough resources to understand investment products or to realize their lack of understanding in which case they can ask to be treated as retail clients.
- Regarding point (i), to differentiate between authorised or regulated institutional investors depending on their main activity may be a source of legal uncertainty. As a result, once an entity has been authorised or is regulated to operate as an institutional investor, no other classification should be required.

- In more general terms, any narrowing of definitions of the various categories in Annex II.I is likely to lead to legal uncertainty, which is neither in the interest of clients nor in the interest of investment firms.

(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?*

No comment. See answer to question 2.

(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?*

If by clarification CESR means an interpretation of the referred categories in the broader context of existing MiFID provisions, such clarification with regard to the respective terms in Annex II.1 (1) might be useful. However, EBF considers that such a clarification should not necessarily amount to a narrowing of the range of entities included in the category “professional investor” for the reasons stated above (see response to question 2).

B. 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. Whilst the EBF considers that the scope of public bodies that manage public debt could be further clarified, that clarification should not result in all local authorities being permanently excluded of the categories of *per se* professional clients. Reasons:

- The territorial scope of an authority that manages public debt is not the determining factor to establish the degree of “professionalism” of such authority as an investor. On the contrary, an assumption operates that authorities that manage public debt - regardless of their territorial footprint - have highly qualified staff, capable of understanding investment products.
- As recognised by CESR (§ 25 of the consultation document), local authorities in some Member States are able to be treated as clients who are considered to be *per se* professionals under Annex II.I.(3). Consequently, a tightening of language in that Annex that may result in local authorities permanently excluded of the categories of *per se* professional clients should be ruled out.

The EBF considers, nonetheless, that the debate around the categorisation of local authorities might be approached in a more straightforward way by establishing a definition of what constitutes a “local authority” in the context of MiFID. This may prove challenging as the ability of local authorities to engage in financial market varies from Member State to Member State, as acknowledged by CESR (§ 26 of the consultation paper).

Under those reservations, the EBF agrees that local authorities that concretely manage public debt should be treated as *per se* professional clients.

C. Other client categorisation issues

(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?*

No. It is the primary responsibility of the client to determine whether it can properly assess or manage the risks involved in its investments (see Annex II.I). That said, pursuant article 19 (1) of MiFID, investment firms - acting honestly, fairly and professionally in accordance with the best interests of its clients - already assess, on the basis of the information available to them, whether, prior to the provision of services, the client is deemed to be a professional client. Consequently, there should be no further assessment.

Furthermore, the case mentioned by CESR (i.e. unregulated undertakings considered as professionals by their size) refers to entities that, broadly speaking, have enough resources to assess products that may be considered “complex” and/or risky. Once again, if those entities consider that they should be treated as retail, they can ask for it.

In addition, as mentioned above (see our response to question 2), directors from entities categorized as *per se* professional, should be deemed professional enough to gauge whether or not they understand a product.

(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?*

The EBF does not think so – see answer to question 6 above.

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

No. As stated above, client categorisation rules do not need to be changed. Furthermore, changes to general, broad client categories should not be made dependant on how clients interact with certain products. The current regime already provides enough flexibility to treat clients on a customised, product by product basis and they always have the possibility to opt for a more protective regime.

In practice, many clients already ask for more protection for certain categories of products and it would not be acceptable for European investment services providers to suffer new regulatory constraints for practices observed, as CESR recognises, only in the USA, for example, in the context of securitisation.

Furthermore, the EBF considers that language in § 35 of the consultation paper opens up more definitional issues than it tries to close, for example, with regard to concepts such as “highly complex products” and “super ECP status”.

With regard to “(highly) complex products”, the EBF reiterates its long-standing view that complexity is not related to the intrinsic characteristics of the products but to the perception by the client and that the dividing line between types of products is difficult to establish. If

CESR, nevertheless, pursues a change in client categorisation rules in relation to product complexity the EBF considers that, in order to make the distinction between the various products more efficient and readable, a secondary distinction based on the risk should be added. As a result, “(highly) complex products” would have an impact on the treatment of the client only if the complexity generates a specific risk, whereas those whose complexity does not generate any specific risk would not.

(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?***

No comment. See answer to question 8 above.

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

In line with answers to questions 6-9, the EBF considers that standards that apply for transactions with an ECP do not need to be clarified as such. The EBF is, nonetheless, supportive of considering the existing standards against the background of other pertinent provisions in MiFID (such as Articles 24 and 25, as CESR points out in § 39 of the consultation paper). The EBF highlights that investment firms do generally act honestly, fairly and professionally with ECPs and communicate with them in a way that is fair, clear and not misleading.

Furthermore, the EBF notes that the unavailability of the ECP categorisation for certain products could potentially lead to banks not being an ECP when trading some of the products they originate. As already stated, where firms feel they do not understand a product they can opt down (which is an option many firms have chosen).

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

No comment. See answer to question 10 above.