Date: 18 October, 2001
Ref.: CESR/01-013b

COVER NOTE TO THE CONSULTATIVE DOCUMENT ON THE HARMONIZATION OF CONDUCT OF BUSINESS RULES

During its last meeting, held on the 11th September 2001, the Committee of European Securities Regulators (CESR) agreed to publish for a second round of public consultation the following documents:

- the revised proposal for harmonisation of core conduct of business rules, including the retail and the professional regimes (ref. CESR/01-015);
- the revised paper on the categorisation of investors (ref. CESR/01-014).

1. Background

In February 2001, Fesco published for consultation the paper on the proposal for the harmonisation of conduct of business rules for investor protection (ref. FESCO/00-124b). The consultative document attracted strong interest and many comments were received, mostly from industry practitioners. Efforts to generate responses from consumer associations were, by contrast, largely unsuccessful. An inventory of all comments received was made publicly available on the Fesco web-site (ref. FESCO/01-109) and despatched to individual respondents as preliminary feedback to their comments.

2. The revision of the original proposals

CESR reviewed its original proposals along the following lines:

- CESR has given full consideration to all the issues and as a result amendments have been made (an explanation of major changes and reasons for change is given in **annex 1**);
- the document which provides the categorisation of investors[1] has been amended to upgrade the large companies and other institutional investors (with the exception of public sector bodies) to the category of professional investors;
- the scope of application of the professional regime has been clarified by specifying the conduct of business requirements to be respected in cases of « counterparty relationships »;
- the structure and content of the document have been simplified.

3. The EU conduct of business regime

An overall presentation of the new proposed « system » for the EU conduct of business regime is given in **annex 2**.

[1] The document was approved by Fesco in March 2000, after a public consultation; however, it explicitly referred to a possible revision in order « to consider whether the harmonised standards are suitable for the proposed categories of professional investors ».

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The different regimes apply to the investment firm-client relationship for investor protection, depending on whether the customer is classed as retail or professional as determined by the categorisation criteria specified in document ref. CESR/01-014.

Furthermore, CESR proposes to identify a regime to apply to "counterparty relationships", which is characterized by the absence of a client relationship (i.e. without any provision of a service), typically between market participants active in the market for their own account. A primary example is the case of the treasury managers of large banks and investment houses dealing amongst themselves. With either no service being provided to a customer or no service needed, there is no need to apply conduct of business rules for investor protection purposes. The regime for "counterparty relationships" is intended to ensure that the relevant principles of Article 11 of the ISD relating to the integrity of the market are fully upheld. Furthermore, it is without prejudice to the applicability of the proposed measures to promote market integrity (ref. FESCO/01-052f). These proposals reflect views on which CESR is particularly interested in receiving comments, pending further analysis on the full compatibility of the proposals with current EU legislation.

4. Other areas included in the consultative paper

CESR continued its work in the areas of cold calling, grey markets and advice; its proposals are now incorporated in the document for the harmonization of conduct of business rules.

Cold Calling.

Negotiations at the level of the Council of Ministers and European Parliament on the Distance Marketing Directive[2] currently envisage leaving the option to individual Member States to authorise cold calling (unsolicited telephone communications) on the basis of either opt-in (prior consent by consumer) and opt-out mechanisms (express objection by consumer).

Given the work at the European level, CESR proposes a regime which applies if and when cold calling is allowed. These standards introduce a degree of convergence in the disciplines to be respected by investment firms or their agents when undertaking unsolicited communications. The drafting of these standards does not prejudice in anyway the possibility of any Member State to elect "opt-in or opt-out mechanism" in respect of cold calling. Nor does it prejudice any existing possibility for a Member State electing an opt-in mechanism for cold calling to enforce its rules in a proportionate manner on incoming unsolicited communications. CESR is particularly interested in receiving comments on its proposals on cold calling.

Advice

A definition of investment advice is now incorporated in the document. CESR proposes that principles and rules for the provision of investment services will also apply to the provision of investment advice where appropriate.

Grey markets

CESR looked at « grey-market activities » from an investor protection perspective and concluded that the proposed regime for investor protection adequately covers these regulatory concerns. Accordingly, no specific proposals have been made in this regard.

5. Consultation

CESR will consult publicly, both at national and EU level. Each member will organise national consultation and CESR will arrange open sessions with industry and investors associations. The consultative documents are available on CESR's web-site (www.europefesco.org) with the invitation to submit contributions directly to CESR. In the interest of rapid progress, we would highly appreciate it if comments could be forwarded preferably by **15 November 2001**, or at latest by the

[2] A political agreement on this Directive was reached in the Council on the 27th September 2001.

end of November, to the Secretary general of CESR (e-mail: fdemarigny@europefesco.org, or 17 Place de la Bourse, 75082 PARIS CEDEX 02, FRANCE, tel. +33 1 53 45 63 61, fax: +33 1 45 63 60).

CESR welcomes comments on all parts of the documents, but there are some areas on which CESR is particularly interested in feed-back:

- the revision of the categorisation of investors, and in particular whether the thresholds to define large companies as professional investors are appropriate;

- the regime for the "counterparties relationships", and in particular:

➢ the criteria to define the "counterparties relationships";
➢ its applicability to large companies;
➢ if this regime does not apply to large companies, whether the professional regime is appropriate;
➢ whether the threshold to define the scope of application to large companies is adequate;
➢ the extension of the proposed regime, with particular regard to prevention of market abuses;

- the proposed regime on cold calling, and in particular whether it would be appropriate to define such regime pending the negotiations of the Distance Marketing Directive;

- the revised regime for reporting serious breaches of conduct of business rules to the supervisory authority;

- the revised regime on conflicts of interest and inducements;

- the revised regime of the internal code of conduct and the scope of its application;

- the revised regime on the "know-your-customer" principle and the duty to care, in particular whether it caters appropriately for low-cost dealing services that do not offer investment advice.

ANNEX 1

EXPLANATION OF CHANGES AFTER THE RESULTS OF CONSULTATION ON THE DOCUMENT FOR THE HARMONIZATION OF CONDUCT OF BUSINESS RULES (FESCO 00-124-B)

Explanation of changes after the results of consultation on the document for the harmonization of conduct of business rules

Foreword

This document aims to explain the reactions of CESR members to comments made during the consultation on the proposed regime for the harmonization of conduct of business rules. The comments of consultees were interesting and informative; they contributed substantially to enhance the quality of the document.

In the light of the extensive amount of comments received and the short time available, the document does not provide explanations on every comment received, but it concentrates on those which were considered to be most important. Nonetheless, the CESR's Experts Group on Investor Protection is willing to provide further explanations, additional to those included in this document, in the course of the next round of consultation.

The explanations follow the same order of the revised consultative document.

Introduction.

Only few drafting amendments have been made in this section. The "objectives" section has been slightly revised. Consultees generally asked the Committee to devote particular attention to the implementation process, having regard to the speed and homogeneity of the implementation. These concerns have been addressed by CESR in Article 4.3. of its charter (ref. CESR/01-002).

Definitions.

Some definitions have been deleted (« direct offer marketing ») or amended (« regulated markets », « written agreement »). The definition of written agreement has been changed to address the request for technology neutrality, raised by many consultees.

The following definitions have been added: « cold calling », « inducements », « interactive communication », « investment advice », « personal recommendation », « soft-commission » and « trading restrictions ».

1. Principles and rules of general application.

The entire section has been simplified and clarified. Principle and rules on cold calling have been added. Outsourcing has been shifted to a separate section, while requirements on procedures (originally confined in the dealing requirements section) have been included in the principles of general application.

1.2. Conflicts of interest and inducements

The sections on conflicts of interest and inducements have been combined.

CESR proposes to regulate conflicts of interests along the following lines. The investment firms must adopt an internal independency policy aimed at preventing conflicts of interest and on inducements. Where conflicts of interest cannot be avoided or managed with Chinese walls, the full disclosure applies.

Furthermore, it has been clarified that disclosure on conflicts of interest may be given either at the beginning of the relationship or before entering into a transaction with the customer.

1.3. Compliance and code of conduct

The two sections raised many comments from consultees. As a result, the sections have been combined and simplified.

CESR considers the duty of investment firms to report serious breaches of conduct of business rules to the competent authorities extremely important for investor protection purposes. CESR attaches great relevance to identify timely the origin and extent of misbehaviours. This objective may be better achieved through direct intervention of the investment firm; alternatively, supervisors would be forced to implement more intensive on-site inspection programmes.

In order to avoid problems of "self incrimination", it has been suggested that an investment firm has the duty to inform the competent authority either directly or through the internal or external auditors. External auditors are already subject to reporting of serious breaches to competent authorities under the existing EU legislation. Furthermore, CESR has provided criteria to assess whether breaches may be considered to be serious.

CESR considers it appropriate to impose to an investment firm the duty to keep a register of complaints; however, details of internal organization have been left in the hands of investment firms.

As regards the period for keeping relevant records, CESR still considers the period of five years to be appropriate and in line with the requirements laid down by the ISD (Article 20).

The scope of application of the code of conduct has been limited to supervisory board, directors, partners, employees and agents.

2. Information to be provided to customers.

Comments on this section were not always easy to reconcile (for example, lacking in flexibility vs. not enough scope for standardisation). An interesting outcome was the differing views amongst the industry as to what is perceived as useful, essential or valuable to the customer. Furthermore, CESR recognises the need for more reactions from consumers in the next round of consultation. Hopefully the next round of consultation will be more successful in that regard.

As regards the use of standard documentation, CESR recognises the use of standard documentation and the proposals are intended to support and complement, not hinder, such practice.

Some changes have been made where it is accepted that a requirement may have been too burdensome. In general, CESR is satisfied that these requirements are appropriate when assessed against existing legislative requirements, duty of care considerations and the increasingly efficient delivery channels that are more widely available.

2.1. Basic requirements

This section has been reduced and simplified to concentrate on what is essential information, as opposed to what may be relevant. The requirements to provide information clearly and on a timely basis have been clarified.

2.2.1. Marketing Communications

The principles have been re-ordered and re-stated more clearly. The intention is to set out some basic standards, not overly detailed or prescriptive contents requirements for different types of advertising. Later references to 'direct offer' marketing communications have been dropped accordingly.

2.2.2. Information about the investment firm

The obligation to notify conflicts of interest has been simplified. More detailed requirements to notify the customer of the firm's legal capacity and individuals with whom he may have contact have been replaced with a more general description of the activities of the firm. The intention is to ensure the customer receives relevant and useful information about who the firm is and the business it undertakes with a view to enabling comparison between potential providers of services.

2.2.3. Information on financial instruments and investment services

Information requirements on charges have been incorporated into this section. The provisions relating to direct offer marketing have been dropped as the general requirements for marketing communications are felt to be adequate. The requirement to advise the customer to seek tax advice has been made less prescriptive.

Overall the level of detail is felt to be appropriate in that it facilitates proper assessment of particular products and services.

2.2.4. Risk warnings

The list of instruments that require risk warnings has been reduced and clarified. Comments on the use of standardised risk warnings are acknowledged and the proposal is designed to accommodate them.

2.3. Customer reporting

The requirement to send a transaction confirmation has been re-stated. There is also no longer a requirement to separately confirm a customer order if it is promptly executed. The comments received on these requirements were particularly useful in shaping the new proposal.

3. The « Know-your-customer » principle and the duty to care.

The structure has been clarified and simplified. Chapter 3.1 deals with the information to be obtained from the customer and chapter 3.2 regulates the investment firm’s duty to care for the customer on the basis of the information disclosed by the customer and available to the firm. The extent of this duty depends on the relationship established between the investment firm and the customer.

3.1. Information from the customer

The section has been simplified and clarified. The principle and rule on the customer refusal to provide information have been added to this section and shortened.

3.2. Execution-only business.

Many comments have been received with regard to this increasingly developing business. Most were aimed at making its regulation more flexible in order to avoid unnecessary and burdensome legal requirements that might hinder the development of this business in the future. CESR in the light of the existing EU legislation and taking into consideration the regulation of this activity in other non-EU countries, has developed two guiding principles:

- *Protection of investors is also necessary in relation to this specific business*: although a more simplified regime than the normal handholding relationship would be appopriate, CESR considers it appropriate to ensure an appropriate level of transparency and confidence in the relationship between the customer and an investment firm, especially in cases of ‘on-line’ execution-only business. The regulation, while giving an appropriate protection to investors, should also reduce the risk of potential future litigation.

- *Regulations should not impose unnecessary duties and burdens in the conduct of this dynamic business:* CESR, taking into consideration the difference in terms of complexity between

execution-only business and other investment services, tried to define a simplified regime in order to achieve the above objective.

The proposed regime introduces elements of flexibility aimed at facilitating the conduct of business in the way that the investment firm defines, at the beginning of the relationship, a set of investment parameters and types of transactions for each customer (which may well be standardised for a large group of customers). Then, the investment firm is requested to actively intervene in the course of the relationship when the customer wishes to depart from his/her initially set investment profile.

4. Customer agreement.

4.1. Basic customer agreement

The section has been slightly simplified. It is now proposed that the basic customer agreement (including standard contractual documentation) should indicate the trading venues to which the firm has direct access, so that the customer can place orders with the firm on the basis of full information in this respect.

On the other hand, it is now proposed that the basic customer agreement does not need to indicate:

- the precise way in which fees and charges are calculated because such information may be very technical and will generally be of very little interest to the customer;

- details of the applicable investor scheme because such schemes are not contractual in nature and the relevant information must be supplied to the customer under the rules on customer information;

- how transactions may be executed outside a regulated market, because other standards, including the best-execution rule and rules on customer information, are deemed sufficient in this regard.

As for the contents of the agreement involving trading in derivatives, only a few wording changes have been introduced.

The possibility for a firm to begin providing certain services to a customer before putting in place a signed agreement where the contract is concluded (orally) by telephone has been eliminated because it is felt that such flexibility would be helpful only in an increasingly small number of cases and that such cases are not sufficient to warrant an exception to the general rule requiring a prior written agreement. Concerns on the written form have been addressed also by amending the definition of written agreement.

5. Dealing requirements.

The section has been simplified and reorganised in a way to avoid overlapping with other sections of the paper (mainly with principles of general application).

Rules on aggregation and allocation of orders have been clarified as well as the rule on front running.

5.1. Tape-recording of phone conversations

Other comments referred to the rules, which require the taping of phone conversation claiming that this would be a violation of the privacy of the customer, it would be too costly and unnecessary. CESR considers it appropriate to maintain this provision, as it may be helpful to both the investment firm and its customers to establish “the facts”, when any differences between them occur. As such it adds to efficiency. It also respond to the general interest, being useful for supervisory purposes in cases such as investigations concerning possible market abuse, etc. In this respect, it is particularly important to be able to examine the record of the order as well as the circumstances in which it took place, the exact wording used by the parties, the role they performed, etc.

An investment firm will inform their customers of the fact that the conversation will be recorded. Therefore, the privacy of the client will not be disrupted.

5.2. "Best execution principle"

The best execution is one of the key principles established by the ISD. Article 11 refers to the fact that investment firms must act in the best interest of the client, therefore best execution has to be given to the investor. CESR has simplified the best execution principle and has tried to clarify the circumstances under which best execution can be achieved. Any default rule on how to execute orders would never cover all different types of orders in all markets and instruments. Furthermore, in light of investor protection, CESR doesn't want to enter into the development of the exchange/trading platforms industry. What remains is an obligation of investment firms to execute orders in such a way that they can always explain how the execution fits in the proposed regime, whereby CESR notes that the burden to look for the best execution obviously is function of the nature and size of the order.

Some consultees pointed out that the principle should be not too open nor too strict. CESR agrees with this, as it doesn't wish to prescribe exactly how and when orders should be executed. It seems to CESR that the proposed principle clarifies effectively the parameters to be taken as a reference to evaluate the fulfilment of the best execution, as well as the fact that the price is not the only parameter to be considered. The concept of relevant market(s) has been clarified to serve the aim of the paper, which is to establish standards for investor protection, offering at the same time workable solutions to investment firms.

6. Discretionary portfolio management section.

Some requirements concerning portfolio management have been deleted in order to avoid redundancies. Some obligations have been clarified and simplified. The main substantial changes in this section are: the amendments to the duty to report performances relative to a benchmark, the deletion from the contract of the procedure of exercising voting right, as well as of any involvement of the customer in the discretionary portfolio management activity, as it does not change the responsibility of the portfolio management firm.

6.1. Customer agreement

The list of items that should be included in the contract has been amended to make it homogeneous with the content of general customer agreement.

The list of specific provisions has been slightly changed, for the sake of clarity. The duty to advise the customer when a product is not authorised to be marketed in his country has been deleted.

Furthermore, the methodology of termination of the contract has to be explained in the contract itself.

As regards the termination of the contract, a distinction has been made between a request to terminate made by the customer and that made by the firm. In case of a client, no delay is required instead of two weeks for a firm.

6.1. Benchmark

CESR has left the obligation to report performances in place. Where customers pay an investment firm to manage their portfolio, CESR finds it reasonable that they are given insight into the (relative) performance of their providers. However, rules concerning the benchmark have been changed. Where it is not feasible to establish such a benchmark due to the specific customer objectives, this must be stated clearly in the contract and an alternative measure of performance must be indicated.

6.1. Delegation

Rules on delegation rules have not been changed despite some comments, namely regarding the possibility to delegate the activity to intermediaries belonging to non-EEA countries. CESR considered this requirement to be necessary both for investor protection and for the effectiveness of the control by regulators.

6.3. Periodic information

CESR has not considered the reporting rules to be too burdensome. More detailed information regarding “the beginning and the end of the reporting period” must be given in the statement. Furthermore, a management report should be sent to the customer at least once a year.

The basis to evaluate financial instruments should be disclosed to the customer through the contract. Changes to these criteria must be indicated in the periodic statement.

The rule on specific reporting requirement in case of losses has been clarified, namely the basis on which losses have to be calculated.

Retail Customers 1

Professionals 2

Counter-parties 3

Investors who may not be treated as professionals

Investors who may be treated as professionals

Financial Institutions

Large Companies

Authorised intermediaries - Companies with sales >2bn Euros”

5

6

6

Retail Regime

Professional Regime

Counterparties Regime 4

CLIENT RELATIONSHIP

Need for Investor Protection

NO CLIENT RELATIONSHIP

Need for Market Integrity

Explicative note

<table>
<tr><td>1</td><td>Retail customers are those who do not fall within the definition of professionals.</td></tr>
<tr><td>2</td><td>Professional investors are:

a) entities which are required to be authorised or regulated to operate in the financial markets (including : credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and management companies of such schemes, pension funds and management companies of such funds, commodity dealers);

b) large companies and other institutional investors, including:

• large companies and partnerships meeting two of the following size requirements:
o balance sheet total : 12.500.000 euro
o net turnover : 25.000.000 euro
o average number of employees during the financial year : 250
• issuers of listed financial instruments, i.e. entities whose securities are traded on a regulated market

c) national and regional Governments, Central Banks, international and supranational insitutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations</td></tr>
<tr><td>3</td><td>« Counterparty relationships » are transactions executed by « market participants » directly active in the market for their own account, withou any provision of service, including:
• inter-dealer transactions executed by authorized investment firms (including non-ISD firms, such as commodity dealers on derivatives markets);
• transactions executed in regulated markets or other organised trading platforms by any member admitted to trade in these markets;
• transactions executed between authorized investment firms and other entities participating in the market, whose annual sales not inferior to 2 Billion of Euros.</td></tr>
</table>

4	The « **counterparties regime** » consists of the following principles: • *The firm must at all times act honestly, fairly and professionally in accordance with the integrity of the market.* • *The firm must have and must employ effectively the resources and procedures that are necessary for the proper performance of its business activities.* • *The firm must establish an independent compliance function, aimed at ensuring that its directors, partners, employees and agents behave in accordance with the integrity of the market.* • *Executive directors/senior management must take reasonable measures to ensure that the firm establishes and implements adequate compliance policies and procedures.* • *The firm must be able to demonstrate that it has acted in compliance with standards of market integrity and that its organisation, policies and procedures facilitate such compliance.* • *The firm must adopt and take all reasonable steps to ensure compliance with an appropriate internal code of conduct* • *The information provided in a marketing communications must be clear and not misleading.* The counterparties have to reciprocally confirm in the contract that the transaction is executed under a « counterparty relationship » and that the above rules for market integrity apply.
5	**Investors who may be treated as professionals on request** (including private individuals) are those meeting the criteria of parr. 12 -14 of the « categorisation paper » (CESR/01-XXX). The procedure of parr. 15-16 of the same paper will apply.
6	Professional investors must be allowed to request non-professional treatment (the extent of which to be agreed with the invetment firm), according to par. 11 of the « categorisation paper ».

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

CESR PROPOSAL FOR THE HARMONIZATION

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 Committee of European Securities Regulators (CESR) 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. CESR 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. CESR members are aware in this respect of the consultative document that has been presented by the European Commission on the revision of 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 CESR members expect investment firms to meet [3].

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.

6. This paper builds on the CESR 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

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[3] These principles and rules apply to "ISD investment firms", as well as to "non-ISD firms" (including commodity derivatives dealers) and ISD investment services, as well as non-core services.

CESR

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).[4] 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 CESR consider to be necessary (as far as subjects dealt with in this paper are concerned) to ensure appropriate investor protection are set out in chapter III for retail customers and in chapter IV for professionals customers. This last chapter contains a selection of these Principles and Rules of chapter III, which should also apply to business relationships between professionals. Core principles for "counterparty relationships" are given in the Annex. Chapter III and chapter IV develop the following sections that apply to an investment firm's relationships with retail customers and professionals:

   Principles and Rules of general application;
   Information to be provided to customers;
   "Know your customer" and suitability (information to be sought from customers);
   Customer agreements;
   Dealing requirements (including the "best execution" principle);
   Discretionary portfolio management.

Implementation

9. CESR 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 CESR 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. CESR is committed to undertake reviews of regulatory practices within the single market, on the basis of Article 4.3. of its Charter.

Objectives of the paper

10. The broad objectives which CESR has focused on when constituting the Principles and Rules are the following:

    a) Ensuring that information provided to customers enables them to 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.

    b) 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;

[4] CESR members are aware that in the European Council a political agreement was reached on the 27th September 2001 on 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 CESR 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.
CESR 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.
CESR 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 European Commission adopted a communication on "e-commerce and financial services".

- includes the customer's trading restrictions or other comparable circumstances which may affect the provision of services;
- ensure that the customer's dealings and any advice given to him are suitable.

c) 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.

d) Ensuring that investment firms:
- operate efficiently, 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.

e) Ensuring that with regard to portfolio management:
- the customer understands the nature and particularities of this service;
- the customer agreement contains all relevant provisions necessary to define this service and includes specific instructions of the customer;
- the customer is regularly informed of the performance of the service;
- the portfolio is managed independently and in accordance with the objectives of the customer.

f) Ensuring that investment firms manage conflicts of interest fairly and provide appropriate disclosure to their customers in this respect.

g) 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.

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 and the integrity of the market.

CESR

II. DEFINITIONS

- **Cash financial instrument:** financial instruments other than derivatives.

- **Cold calling:** any unsolicited interactive communication with a potential customer[5], for example, a personal visit or a telephone call initiated by a person acting on behalf of an investment firm, and which has not been requested or expressly permitted by the customer (see also the definition of "interactive communication").

- **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).

- **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 commodity derivatives.

- **Inducements:** soft commissions, kick-back commissions and any other similar payments in cash or in kind received by an investment firm (or a person employed by the firm) related to the provision of its services.

- **Interactive communication :** any oral communication either with the physical presence or at distance (example by telephone). It also includes any future form of interactive communication which becomes possible as a result of advances in technology.

- **ISD**: Directive 93/22 on investment services in the securities field.

- **Investment advice**: a service which consists of providing advice or personal recommendation to a customer related to one or more financial instruments.

- **Investment firm:** firms as defined in point 2 and 3 of Article 1 of Directive 93/22/EEC. Where appropriate in the context, the term covers non-ISD firms providing investment services, in particular commodity derivatives dealers.

- **Investment service:** any of the services mentioned in section A of the annex to the ISD. Where appropriate in the context, the term covers 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.

[5] Potential customer should include existing customers who are cold called for investment services or products different from those they have already purchased from the firm.

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- **Leverage:** the ratio of the market exposure of a portfolio to the exposure it would have if the portfolio were 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.

- **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, radio, television, 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) securities research reports, 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.

- **Personal recommendation**: a recommendation given to a customer taking into account his specific situation, namely, his financial objectives, financial resources, background and knowledge on financial matters.

- **Professional:** a professional customer.

- **Regulated markets:** markets which comply with the requirements of article 1.13 of the ISD.

- **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.

- **Trading restrictions**: general prohibitions on trading in financial instruments and particular restrictions applicable to specific types of financial instruments. These restrictions may derive, *inter alia*, from the law, from public regulation or self-regulatory arrangements, from articles of associations or other internal rules, and may result from the relevant person's legal capacity or status, type of employment or position within an entity.

- **Written agreement:** a contract in writing or in a similar unalterable electronic form having equivalent evidentiary status [6]. Information to be given "in writing" is to be understood in the same way.

[6] Community legislation provides a legal framework for the use of electronic contractual documents, including Directive 2000/31/EC on electronic commerce and Directive 1999/93/EC on electronic signatures.

<u>III. CORE CONDUCT OF BUSINESS RULES FOR THE « RETAIL REGIME »</u>

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 and the integrity of the market.***

2. ***An investment firm must have and must employ effectively the resources and procedures that are necessary for the proper performance of its business activities, including back-up procedures and systems so as to reasonably ensure that investment services can be provided without interruption.***

3. ***In the course of providing investment services to a customer, an investment firm must ensure that any persons or entities with which it is undertaking authorisable investment business are authorised to conduct that business.***

1.2. CONFLICTS OF INTEREST AND INDUCEMENTS

- ***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. For these purposes the investment firm must establish an internal independence policy, including Chinese walls as appropriate, designed to prevent conflicts of interest.***

5. ***Where inducements are received in connection with business undertaken for the customer, adequate disclosure of such inducements must be made to the customer.***

- ***RULES***

6. Where conflicts of interests arise, an investment firm should act in the best interest of the customer, by establishing an internal independency policy aimed at preventing and managing these conflicts. Where the conflicts cannot be reasonably avoided or managed with Chinese walls, an investment firm must 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, joint provision of more than one service or other business dealings of the investment firm or any affiliated entity, unless 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.

7. The disclosure to the customer and the agreement by the customer must be given at the beginning of the relationship, where applicable, or before entering into a transaction either in writing or by telephone and recorded by the investment firm.

8. Where cash inducements are received, or are to be received at a later stage, in the course of business undertaken for the customer, an investment firm must inform the customer at the

beginning of the relationship and at least once a year in writing of the relevant details of such inducements. The same applies where an investment firm has received inducements in kind, which may materially affect the provision of the service to the customer.

1.3 COMPLIANCE AND CODE OF CONDUCT

- ***PRINCIPLES***

9. ***Executive directors/senior management must take reasonable measures to ensure that the investment firm is acting in accordance with the best interests of its customers and the integrity of the market by establishing and implementing adequate compliance policies and procedures.***

10. ***An investment firm must establish an independent compliance function and an internal code of conduct, aimed at ensuring that members of the supervisory board, directors, partners, employees and agents behave in accordance with the best interests of its customers and the integrity of the market.***

11. ***An investment firm must be able to demonstrate that it has acted in compliance with the conduct of business rules and the internal code of conduct and that its organization, policies and procedures facilitate such compliance.***

- ***RULES***

12. The persons responsible for the compliance function must have the necessary expertise, resources and authority and must perform their monitoring duties independently.

13. The results of the monitoring must be reported to the senior management of the investment firm and to the internal or external auditors. The investment firm must report these results, together with remedies adopted, to the competent authority at least once a year.

14. An investment firm must ensure that the competent authority is informed, without undue delay, of serious breaches of the conduct of business rules, either directly or through the internal or external auditors. In assessing whether the breaches are serious, an investment firm must take into account the impact on regulatory goals and on the capacity to provide services, their frequency, the damages suffered by customers, and the corresponding remedies adopted by the investment firm.

15. The compliance function must:

    a) regularly verify the adequacy of policies and procedures to ensure compliance with the regulations on investment services;
    b) regularly verify whether complaints relating to investment services are adequately processed;
    c) provide advisory assistance and support to the various business areas of the investment firm on problems concerning compliance with the regulations on investment services.

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 competent authority to verify compliance with the conduct of business rules.

18. An investment firm must keep a register of customer complaints related to the provision of the investment services and the measures taken for their resolution.

19. An investment firm must establish a code of conduct for members of the supervisory board, directors, partners, employees and agents. 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 conflicts of interest and inducements.

1.4. OUTSOURCING

- ***PRINCIPLE***

20. ***An investment firm that outsources activities, which might affect the provision of investment services to its customers, retains full responsibility for the outsourced activity [7].***

- ***RULE***

21. An investment firm that outsources activities, which might affect the provision of investment services to its customers, shall ensure that the choice of providers of such outsourcing is based on their ability to perform the services reliably, professionally and in the best interests of its customers.

1.5. COLD CALLING [8]

- ***PRINCIPLE***

22. ***For the purpose of protecting customers from undue pressure to enter into a contract, cold calls can only be made to potential customers in accordance with the rules set out below.***

- ***RULES***

23. Cold calls may only be made by persons employed by, or appointed as agent by an investment firm. Responsibility for the competence and activities of such persons rests with the firm.

24. An investment firm cold calling customers may do so only between the hours of 9.00 a.m. and 9.00 p.m. Monday to Friday (local time for the customer) and excluding local national holidays.

25. The identity of the person making the cold call, the investment firm on whose behalf the person is acting, and the commercial purpose of the cold call must be explicitly identified at the beginning of any conversation with the consumer. The caller must also make reference to the frozen period (see par. 29) during which orders may not be executed.

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[7] This principle is not intended to interfere with relevant provisions on civil liability, applicable at national level.
[8] These rules are without prejudice to any provisions of EU law governing the means whereby or conditions under which an investment firm or its agent may initiate unsolicited contacts with a prospective customer.

26. The person making the cold call is also required to establish whether the potential customer wishes the cold call to proceed or not.

27. An investment firm must abide by a request from the customer either to end the cold call and/or not to cold call again.

28. An investment firm must not exert undue pressure on a potential customer during the course of a cold call and must be able to demonstrate that this is the case, for example, by recording any such telephone calls.

29. While a contract for investment services may be concluded during a cold call such contract will not come into effect for a period of 14 days. This period will end on the later of the following:

- 14 days after the conclusion of the contract or
- 14 days after the day on which the consumer receives the contractual terms and conditions and the prior information in accordance with Art. 3.1b (1)or (2) of Directive ..../.../EC (i.e. adopted Distance Marketing Directive).

During this period the firm may not execute any orders for the customer foreseen by the contract.

2. INFORMATION TO BE PROVIDED TO CUSTOMERS

2.1) BASIC REQUIREMENTS

- **PRINCIPLES**

30. An investment firm must pay due regard to the information needs of its customers and communicate information to them that is fair, clear, and not misleading.

31. An investment firm must supply its customers on a timely basis with the information that enables them to make informed investment decisions.

- **RULES**

32. 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 method of presentation of the information must not disguise, diminish or obscure important warnings or statements.

33. In supplying information on a timely basis the investment firm must take into consideration: a) the urgency of the situation and b) the time necessary for a customer to absorb and react to the information provided.

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

2.2.1) MARKETING COMMUNICATIONS

- ***PRINCIPLES***

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34. If an investment firm provides information in a marketing communication it must be fair, clear and not misleading.

35. The promotional purpose of marketing communications issued by an investment firm must not be disguised.

- ***RULES***

36. The information provided by an investment firm in a marketing communication must be consistent with the information it provides to its customers before and during the provision of the investment services.

37. Any marketing communication must contain at least the information about the investment firm defined in points a) and b) of paragraph 41. 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.

38. An investment firm must not use the name of the competent authority in such a way that would indicate endorsement or approval of its services.

39. 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 45.

2.2.2) INFORMATION ABOUT THE INVESTMENT FIRM

- **PRINCIPLE**

40. Before providing investment services an investment firm must supply adequate information about itself and the services it provides.

- ***RULE***

41. An investment firm must provide customers with the following information prior to the provision of investment services:
    a) the identity of the investment firm, the (financial) group to which the investment firm belongs, its postal address and telephone number;
    b) 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;
    c) the functions that the investment firm performs so that the customer is able to assess the scope of the firm's responsibilities (e.g. a firm offering an execution-only service must inform the customer that it will not provide investment advice or any personal recommendation);
    d) the relevant compensation scheme(s);

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e) where such a procedure exists, a description of the mechanism(s) for settling disputes between the parties such as an out-of-court complaint and redress mechanism;
f) an outline of the firm's policies in relation to conflicts of interest and inducements;
g) the languages in which the customer can communicate with the investment firm.

2.2.3) INFORMATION ON FINANCIAL INSTRUMENTS AND INVESTMENT SERVICES

- ***PRINCIPLES***

42. In the course of conducting 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.

43. In the course of conducting 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.

44. ***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***

45. An investment firm must inform 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. Standard documentation may be used, where appropriate. 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, relating to the transaction, the instrument or service;
    c) arrangements for payment and performance;
    d) details on any cancellation rights or rights of reflection that may apply.

46. The information to be disclosed to customers on commissions, charges and fees must contain:
    a) the charges for transactions, products or services, 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 estimate of the other fees that will be payable.

47. 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.

48. The fair and adequate description of a compound product must contain all the relevant characteristics of the composite instruments including, for example, the different services involved, the duration of the product, whether the instrument involves credit, the interest due, etc.

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49. 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 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.

50. When information provided refers to a particular tax treatment the investment firm must advise the customer that the tax treatment depends on his personal situation and is subject to change and that he may wish to obtain independent tax advice.

51. 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 may not constitute reliable guidance as to the performance of these services and instruments in the future.

52. 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 a compound annual rate or stated separately as annual returns;
    c) where a compound 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;
    g) the information for the comparison should be based on net performances or if it is based on gross performances commissions, fees or other charges have to be disclosed.

53. The relevant provisions on actual returns shall apply to the method of calculating and presenting any future returns. Information on estimated future returns must state that these future returns are forecasts. Such forecasts must in turn be based on objective, realistic assumptions of investment returns.

54. 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.

55. If information provided contains comparisons, the requirement of being fair, clear and not misleading means that the comparisons must:
    a) be based either on data from attributed sources or disclosed assumptions;
    b) be presented in a fair and balanced way;
    c) take reasonable steps not to omit any fact that is material to the comparison.

Derivatives and leveraged transactions

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

2.2.4 RISK WARNINGS

- ***PRINCIPLES***

57. An investment firm must provide its customers with 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.

58. ***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***

59. An investment firm must provide its customers with 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;
    - transactions in illiquid financial instruments;
    - leveraged transactions;
    - financial instruments subject to high volatility;
    - securities repurchase agreements or securities lending agreements;
    - transactions which involve credit, margin payments or the deposit of collateral;
    - transactions involving foreign exchange risk.

    The investment firm must also, where necessary, inform the customer of risks associated with:
    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 or listing (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).

60. 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.

2.3. CUSTOMER REPORTING

- ***PRINCIPLES***

61. An investment firm must ensure that customers are provided promptly with the essential information concerning the progress of execution of any transaction they undertake.

62. Where an investment firm has control of, or is holding assets belonging to a customer, it must arrange for proper identification and regular confirmation of such assets to the customer.

63. ***An investment firm that operates customer accounts, which include open positions in derivatives, must provide regular statements of such positions.***

- *RULES*

a) Customer order and transaction information

64. No later than the first business day following the execution of the transaction an investment firm must send to the customer[9], by fax, mail or electronic means (provided the firm reasonably believes that 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, if available, 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 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 (name and number) of the bank account and securities account.

    If a transaction is executed later than the first business day after the order was received, an investment firm must also 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.

65. Any refusal by the firm to accept or transmit a customer order, or inability to transmit it, must be notified immediately.

b) 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.

c) Derivatives and leveraged transactions

67. Where an account includes uncovered open 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;
    b) each payment made by the customer as a result of the margin requirements in respect of the open positions and the amount of the unrealised profit or loss attributable to open positions;
    c) the resulting profit or loss arising from positions closed during the period.

[9] The reference to "send to the customer" includes to an agent, other than the firm, nominated by the customer in writing.

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3. THE "KNOW-YOUR-CUSTOMER PRINCIPLE" AND THE DUTY TO CARE

3.1 INFORMATION FROM THE CUSTOMER

- ***PRINCIPLE***

68. Prior to providing any investment service to a customer for the first time and throughout the business relationship, an investment firm must be in possession of the documentation on the identity of the customer, as well as the identity and legal capacity of any representative of the customer.

In addition, prior to providing any investment service the investment firm must seek to obtain from the customer information enabling an investment firm to determine the investment services and financial instruments that would be appropriate for the customer, including the customer's knowledge and experience in the investment field, his investment objectives and risk profile, his financial situation/capacity and any trading restrictions applicable to the customer.

- ***RULES***

69. The "know-your-customer" principle applies to each investment firm having a direct business relationship with the customer. However, where two or more investment firms are involved in providing an investment service and each has a direct relationship with the customer, an investment firm may rely on the information received from another of such investment firms.

70. An investment firm must obtain evidence of the identity of its 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, an investment firm may not provide any investment services to the customer concerned.

71. 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.

72. Information on the customer's investment objectives and risk profile includes the temporal horizon of the customer's future investments, as well as his preferences regarding risk-taking and recurrent income.

73. An investment firm shall be entitled to rely on the information provided by the customer, unless it is manifestly inaccurate or incomplete or the firm is aware that the information is inaccurate or incomplete.

74. An investment firm must take reasonable care to keep the customer profile under review, also taking into consideration the development of the relationship between the investment firm and the customer. 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. Should the firm become aware of a major change in the situation previously described by the customer, it must request additional information.

75. 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 profile, as well as records of customer addresses and telephone/fax numbers.

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76. An investment firm must warn the customer that any refusal to supply information may adversely affect the ability of the investment firm to act in the best interest of the customer. If the investment firm nonetheless wants to accept a customer order it has to proceed according to paragraph 81.

77. The possibility not to provide information must not be an option offered in a questionnaire.

3.2 THE INVESTMENT FIRM'S DUTY TO CARE FOR THE CUSTOMER [10]

- ***PRINCIPLES***

78. When an investment firm provides investment advice or a personal recommendation to the customer, it must have reasonable grounds to believe, in light of the information disclosed to it by the customer and the information available to it, including the information arising from the customer relationship, that this investment advice or recommendation is suitable for him.

79. An investment firm must check before accepting an order if the order is suitable for the customer.

80. An investment firm must take reasonable care to 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 – in the light of the information disclosed to it by the customer and the information available to it, including the information arising from the customer relationship – not suitable for the customer, it must advise the customer accordingly and provide appropriate information on the transaction, including any necessary risk warning. The investment firm may transmit or execute the order only if the customer nonetheless confirms his intention to proceed with the transaction in writing, in a similar verifiable manner or by telephone and recorded, and provided that such confirmation contains 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 having taken reasonable steps to verify the immediate availability of the funds (securities) necessary for carrying out the related purchase (sale) only if an adequate credit facility has been agreed on beforehand.

83. When the service to be provided is the pure transmission or execution of orders (either through a special distribution channel, in individual cases or generally), without any investment advice or personal recommendation, the customer must be made aware of this fact prior to the transaction taking place. The investment firm will define investment parameters and types of instruments for the contemplated transactions of the customer on the basis of the information obtained from the customer. Where the investment firm receives an order regarding a transaction, which is not in line with the investment parameters and types of instruments defined, it must warn the customer accordingly and provide appropriate information on the transaction, including necessary risk warning(s). The investment firm may transmit or execute

[10] After having obtained the information from the customer according to chapter 3.1., an investment firm's duty to care for the customer depends on the nature of the relationship established with the customer, i.e. whether investment advice or personal recommendations will be provided (par. 78-82 apply) or the service to be provided is the pure transmission or execution of orders (par. 83 applies).

the order only if the customer nonetheless confirms his intention to proceed with the transaction in writing, in a similar verifiable manner or by telephone and recorded, and provided that such confirmation contains an explicit reference to the warning received.

4. CUSTOMER AGREEMENTS

4.1) BASIC CUSTOMER AGREEMENT

- ***PRINCIPLES***

84. Prior to providing any investment service, an 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.

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

- ***RULES***

86. 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 services;
    - d) any particular terms agreed between the parties;
    - e) a general description of the services, including custody, offered by the investment firm and the types of financial instruments to which such services relate;
    - f) the types of orders and instructions that the customer may place with the investment firm, the medium/media for sending them (e.g. by telephone, E-mail or post) and the alternative medium to be used when normal media are unavailable, the trading venues to which the investment firm has direct access;
    - g) the information to be given by the investment firm to the customer regarding the performance of services including the medium/media for sending the information and the type, frequency and rapidity of the information to be given e.g. regarding order execution or portfolio evaluation;
    - h) complete details of the investment firm's fees and prices, including the frequency with which they are to be charged and the manner of payment;
    - i) the name of the competent authority which has authorised the investment firm;
    - j) the law applicable to the contract, as ascertained to the best of the knowledge of the firm or as agreed between the parties;
    - k) the duration of the agreement and the procedures for amending, renewing, terminating or withdrawing from it;
    - l) 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;
    - m) 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;
    - *n)* the languages in which the customer can communicate with the investment firm.

87. Rather than containing all the above items itself, the contract may refer to other documents containing certain of them, e.g. 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.

88. Where a custody service related to the other services provided by the firm to the customer is provided, either directly by the investment firm party to the contract with the customer or indirectly by another investment firm, the contract must contain at least a brief indication of the rights and obligations of the parties, including the provisions relating to the exercise of voting rights attaching to the securities held.

89. 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.

90. 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.

4.2) CUSTOMER AGREEMENT INVOLVING TRADING IN DERIVATIVES

- ***PRINCIPLE***

91. ***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 certain additional provisions specific to trading in derivatives must be signed between the parties.***

- ***RULES***

92. In addition to the relevant items of the basic customer agreement, the customer agreement involving trading in derivatives must contain:
    - 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.

93. The contract must mention the types of transactions envisaged, in particular whether the customer intends to undertake transactions giving rise to contingent liabilities, 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.

94. 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.

95. The contract, or the documentation referred to in the contract, must provide adequate 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. This document must indicate how margin will be calculated and charged, the assets (cash, securities,

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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.

96. 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 or type of customer involved, and should be given due prominence in the contract.

5.- DEALING REQUIREMENTS

5.1) RECEPTION AND TRANSMISSION OF CUSTOMER ORDERS

- ***PRINCIPLES***

97. An investment firm must ensure that orders are recorded and processed in such a way as to facilitate best execution and to ensure that orders are executed in accordance with the instructions from the customer.

98. An investment firm must ensure that the firm, its directors or employees do not use the information they possess on customers orders to the disadvantage of customers' interest.

- ***RULES***

Reception

99. An investment firm must ensure that, prior to their transmission for execution, orders given by customers are clear and precise and include the following:
    a) the name of the customer and of any person acting on his behalf,
    b) the date and time of the order,
    c) the financial instrument to be traded,
    d) the size of the order,
    e) the 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, validity period and market of execution,
    g) the account for which the order has to be executed.

100. An investment firm must document and maintain records of orders received from its customers. An investment firm must record orders immediately, documenting and verifying all relevant items for proper execution.

101. AN INVESTMENT FIRM MUST KEEP A RECORD OF TELEPHONE ORDERS ON MAGNETIC TAPE OR AN EQUIVALENT MEDIUM. IT MUST DULY INFORM THE CUSTOMER THAT THE CONVERSATION WILL BE RECORDED.

102. 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

103. An investment firm must transmit orders promptly and sequentially.

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104. An investment firm must take reasonable steps to refrain from transmitting orders for its own account before those of customers in identical or better conditions than the latter ("front running").

105. An investment firm, which aggregates orders, must pre-assign such orders prior to transmitting them.

106. An investment firm may transmit orders for its own account and for its customers account on an aggregated basis only if such aggregation is clearly in accordance with the best interest of the customer and provided that the best execution principle is respected.

107. In the case of orders in connection with public offers of securities, an investment firm may transmit such orders only after offering the relevant prospectus to the customer or informing him on the way to obtain it.

5.2) EXECUTION OF ORDERS

- ***PRINCIPLES***

108. ***An investment firm acting as agent must take all care to obtain the best possible result for the customer with reference to price, costs born by the customer, size, nature of the transactions, time of reception of order, speed and likelihood of execution and trading venue, taking into account the state of the relevant market(s). The relevant market(s) shall be deemed to be the market(s) offering the most favourable conditions also in terms of transparency, liquidity and clearing and settlement arrangements in connection with the envisaged transaction. If the investment firm executes in another trading venue, it must demonstrate to the customer that this was done in accordance with his best interest.***

109. An investment firm acting as principal in relation to a customer order, prior to entering into the transaction, must 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).

110. An investment firm must ensure that orders are executed in accordance with the instructions from the customer.

- ***RULES***

111. An investment firm must take reasonable steps to refrain from executing orders for its own account before those of customers in identical or better conditions than the latter ("front running").

112. 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.

113. Customer orders may be offset only if such offsetting is clearly in accordance with the best interest of the customers involved and provided that the best execution principle is respected.

114. If an investment firm aggregates orders, it must pre-assign such orders prior to executing them.

115. The price received or paid by the customer in an agency trade shall be identified separately from the all fees and costs to the customer.

116. An investment firm must provide customers with information of specific risks or impediments relating to the execution of their orders. If, due to market conditions, or for any other reason, an order cannot be executed according to the instructions given by the customer, an investment firm must ensure that the customer is duly informed as soon as possible.

5.3) POST- EXECUTION OF ORDERS

- ***PRINCIPLES***

117. An investment firm must establish internal policies for the proper recording, allocation and distribution of executed transactions.

118. Where orders for own and customers accounts have been aggregated, the investment firm must not allocate the related trades in any way that is detrimental to any customer. If such aggregated orders are only partially executed, allocation to customers must take priority over allocation to the investment firm.

- ***RULES***

119. An investment firm must record the essential elements of transactions, including those carried out for its own account, immediately after their execution. An investment firm must record in an analogous manner the orders they give and the transactions they carry out for the purpose of remedying errors made in recording, transmitting or executing orders.

120. 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 or executed the order.

121. When, in the best interest of the customer, an order is to be executed in two or more tranches, an investment firm must inform the customer about the price of execution of each tranche, unless the customer has agreed to receive an average price.

122. If customer orders have been aggregated and such an aggregated order has been partially executed, an investment firm must allocate the related trade on a proportional basis, unless the firm has a different allocation policy and the customer involved have been informed accordingly beforehand the execution or in the customer agreement.

123. 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 its customers for whom it deals.

6. INDIVIDUAL DISCRETIONARY PORTFOLIO MANAGEMENT

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

6.1. CUSTOMER AGREEMENTS FOR DISCRETIONARY PORTFOLIO MANAGEMENT

- ***PRINCIPLES***

124. 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 certain additional provisions specific to portfolio management must be signed between the parties.

125. 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 customer's interests.

- **RULES**

126. Instead of the items referred to in paragraph 86.f) , the customer agreement must contain:
  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.

  In addition to the above, the customer agreement must contain:

  c) the benchmark against which performance will be compared,
  d) the basis on which the instruments are to be assessed at the date of valuation,
  e) details regarding the delegation of the management function where this is permitted.

127. The contract must indicate the objectives and the level of risk agreed upon, and any particular constraints on discretionary management resulting from the customer's personal circumstances as referred to in paragraph 68 or his request to exclude certain types of investments (certain business sectors for example).

128. If an investment firm is mandated 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,
  - illiquid or highly volatile financial instruments,
  - leveraged transactions,
  - securities repurchase agreements or securities lending agreements,
  - transactions involving credit, margin payments or deposit of collateral,
  - transactions involving foreign exchange risk.

129. For information purposes with respect to the customer, the contract must indicate an appropriate benchmark, based on financial indicators produced by third parties and in common use, that is consistent with management objectives and against which the future results are to be compared. Where it is not feasible to establish such a benchmark in view of specific customer objectives, this must be stated clearly in the contract and an alternative measure of performance must be indicated.

130. The contract must state whether the instruments are to be valued at bid/ask or offer or mid-market price, including any relevant currency exchange rates, and, where relevant, by reference to indicators such as yield curves or other pricing models or the methodology to be used to value unlisted equities.

131. The contract must define a specific reporting requirement in the event of losses, defined as a marked-to-market decrease in the value of the portfolio as compared to the value of the portfolio as stated in the most recent periodic report (after neutralisation of any contributions or withdrawals, dividends received, etc.). The contract must set a percentage threshold and a time period to warn the customer accordingly.

132. 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.

133. The contract must provide:

- that the customer may terminate the agreement with immediate effect, subject only to the time necessary to liquidate the portfolio where this is required by the customer;
- that the investment firm may terminate the agreement subject to a two-week notice, provided however that where the portfolio cannot be liquidated (where required by the customer) within this timeframe, the agreement may be extended for the necessary additional period, and provided that where the customer so agrees after being informed of the firm's intention to terminate, the agreement may be terminated in the timeframe agreed between the parties.

In both cases, the termination must take place on terms that are fair and reasonable for both parties.

Delegation of portfolio management

134. If an investment firm is mandated to delegate management of any or all of the customer's 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.

135. 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 so authorised in its home country only if an appropriate formal arrangement between regulators enables them to exchange material information concerning both cross-border delegations and the delegatee.

136. 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 delegatee 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 delegatee 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 delegatee permitting the exact reconstruction of the assets under management belonging to each customer of the delegator.

6.3 PERIODIC INFORMATION

- ***PRINCIPLE***

137. An investment firm must send periodic statements to its portfolio management customers so as to enable them to assess the performance of the service.

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138. 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 and the performance (or other valuation) and the cash balance, at the beginning and at the end of the reporting period;
   b) a management report on the strategy implemented (to be provided at least yearly);
   c) the total amount of fees and charges incurred during the period and an indication of their nature;
   d) information on any remuneration received from a third party in connection with the portfolio;
   e) the total amount of dividends, interest and other payments received during the period.

139. If the basis for valuing any of the assets in the portfolio has changed with respect to the methods described in the portfolio management agreement, these changes must be indicated in the statement along with their impact on profits and/or losses.

140. 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.

141. WHERE THE CUSTOMER DOES NOT RECEIVE IMMEDIATE INFORMATION ON EACH TRANSACTION CARRIED OUT BY THE PORTFOLIO MANAGER, THE PERIODIC STATEMENT CONTAINING DETAILS OF EACH TRANSACTION MUST BE PROVIDED AT LEAST EVERY THREE MONTHS. WHERE THE DETAILS OF EACH TRANSACTION ARE NOTIFIED IMMEDIATELY TO THE CUSTOMER, THE PERIODIC STATEMENT MAY BE PROVIDED ONLY EVERY SIX MONTHS.

142. WHERE THE CONTRACT AUTHORISES A LEVERAGED PORTFOLIO, THE CUSTOMER MUST RECEIVE A PERIODIC STATEMENT AT LEAST ONCE A MONTH, INCLUDING AN ASSESSMENT OF THE RISKS.

6.4 MANAGEMENT REQUIREMENTS

- ***PRINCIPES***

143. An investment firm must take all reasonable 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.

144. 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.

145. 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 agreed management objectives.

- ***RULES***

146. The structure of the investment firm, its policies and procedures must seek to ensure the independence of the portfolio management function.

147. The investment firm must maintain records of its investment strategies, as well as the analyses and forecasts underlying them.

148. The investment firm must ensure that its orders are executed as efficiently as possible and in particular that:

a) orders issued are immediately recorded by the firm;
b) transactions executed are recorded and the portfolios affected are adjusted as quickly as possible;
c) the portfolios affected and the relevant amounts are determined, or objectively determinable, no later than the time at which the order is issued and cannot be changed, except for the purposes of rectifying an error, after the execution of the order, regardless of whether the order relates to one or more accounts.

IV. CORE CONDUCT OF BUSINESS RULES FOR THE « PROFESSIONAL REGIME »

1. PRINCIPLES AND RULES OF GENERAL APPLICATION

1.1 GENERAL

149. An investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of its customers [11] and the integrity of the market.

150. An investment firm must have and must employ effectively the resources and procedures that are necessary for the proper performance of its business activities, including back-up procedures and systems so as to reasonably ensure that investment services can be provided without interruption.

151. In the course of providing investment services to a customer, an investment firm must ensure that any persons or entities with which it is undertaking authorisable investment business are authorised to conduct that business.

1.2. CONFLICTS OF INTEREST AND INDUCEMENTS

152. 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. For these purposes the investment firm must establish an internal independence policy, including chinese walls as appropriate, designed to prevent conflicts of interest.

153. Where inducements are received in connection with business undertaken for the customer, adequate disclosure of such inducements must be made to the customer on his request.

1.3 COMPLIANCE AND CODE OF CONDUCT

154. Executive directors/senior management must take reasonable measures to ensure that the investment firm is acting in the best interests of its customers and the integrity of the market by establishing and implementing adequate compliance policies and procedures.

155. An investment firm must establish an independent compliance function and an internal code of conduct, aimed at ensuring that members of the supervisory board, directors, partners, employees and agents behave in accordance with the best interests of its customers and the integrity of the market.

156. An investment firm must be able to demonstrate that it has acted in compliance with the conduct of business rules and the internal code of conduct and that its organisation, policies and procedures facilitate such compliance.

157. The persons responsible for the compliance function must have the necessary expertise, resources and authority and must perform their monitoring duties independently.

[11] "Customer" is intended to be a "professional customer" according to the categorisation paper.

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158. The results of the monitoring must be reported to the senior management of the investment firm and to the internal or external auditors. The investment firm must report these results, together with remedies adopted, to the competent authority at least once a year.

159. An investment firm must ensure that the competent authority is informed, without undue delay, of serious breaches of the conduct of business rules, either directly or through the internal or external auditors. In assessing whether breaches are serious, an investment firm must take into account the impact on regulatory goals and on the capacity to provide services, their frequency, the damages suffered by customers, and the corresponding remedies adopted by the investment firm.

160. The compliance function must:

a) regularly verify the adequacy of policies and procedures to ensure compliance with the regulations on investment services;
b) regularly verify whether complaints relating to investment services are adequately processed;
c) provide advisory assistance and support to the various business areas of the investment firm on problems concerning compliance with the regulations on investment services.

161. The persons responsible for the compliance function must have full access to all relevant information enabling them to perform their duties.

162. An investment firm must keep relevant records for a period of five years in order to enable the competent authority to verify compliance with the conduct of business rules.

163. An investment firm must keep a register of customer complaints related to the provision of the investment services and the measures taken for their resolution.

164. An investment firm must establish a code of conduct for members of the supervisory board, directors, partners, employees and agents. 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 conflicts of interest and inducements.

1.4. OUTSOURCING

165. An investment firm that outsources activities, which might affect the provision of investment services to its customers, retains full responsibility for the outsourced activity[12].

2. INFORMATION TO BE PROVIDED TO CUSTOMERS [13]

166. An investment firm must pay due regard to the information needs of its customers and communicate information to them that is fair, clear, and not misleading.

[12] This principle is not intended to interfere with relevant provisions on civil liability, applicable at national level.
[13] CESR members are aware of the fact that directive 2000/31/EC (e-commerce) provides for certain rules on information to be provided by the service provider to professionals.

167. An investment firm must ensure that customers are provided promptly with the essential information concerning the progress of execution of any transaction they undertake.

168. Where an investment firm has control of, or is holding assets belonging to a customer, it must arrange for proper identification and regular confirmation of such assets to the customer.

169. An investment firm that operates customer accounts, which include open positions in derivatives, must provide regular statements of such positions.

3. THE KNOW-YOUR-CUSTOMER PRINCIPLE AND THE DUTY TO CARE

170. Prior to providing any investment service to a customer for the first time and throughout the business relationship, an investment firm must seek to obtain from its customers information regarding their financial situations, investment experience and objectives as regards the services requested and must be in possession of the documentation of the identity of the customer, as well as the identity and legal capacity of any representative of the customer.

171. When the investment firm provides investment advice or a personal recommendation to the customer, it must have reasonable grounds to believe, in light of the information disclosed to it by the customer and the information available to it, including the information from the customer relationship, that this advice/recommendation is suitable for him.

4. CUSTOMER AGREEMENTS

172. Prior to providing any investment service, an investment firm must enter into a written agreement with the customer setting out the rights and obligations of the parties.

5.- DEALING REQUIREMENTS

5.1) RECEPTION AND TRANSMISSION OF CUSTOMER ORDERS

173. An investment firm must ensure that orders are recorded and processed in such a way as to facilitate best execution and to ensure that orders are executed in accordance with the instructions from the customer.

174. An investment firm must ensure that the firm, its directors or employees do not use the information they possess on customers orders to the disadvantage of customers' interest.

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

176. AN INVESTMENT FIRM MUST KEEP A RECORD OF TELEPHONE ORDERS ON MAGNETIC TAPE OR AN EQUIVALENT MEDIUM. IT MUST DULY INFORM THE CUSTOMER THAT THE CONVERSATION WILL BE RECORDED.

5.2) EXECUTION OF ORDERS

177. An investment firm acting as agent must take all care to obtain the best possible result for the customer with reference to price, costs born by the customer, size, nature of the

transactions, time of reception of order, speed and likelihood of execution and trading venue of execution, taking into account the state of the relevant market(s). The relevant market(s) shall be deemed to be the market(s) offering the most favourable conditions also in terms of transparency, liquidity and clearing and settlement arrangements in connection with the envisaged transaction. If the investment firm executes in another trading venue, it must demonstrate to the customer that this was done in accordance with his best interest.

178. An investment firm acting as principal in relation to a customer order, prior to entering into the transaction, must 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).

179. An investment firm must ensure that orders are executed in accordance with the instructions from the customer.

180. An investment firm takes reasonable steps to refrain from executing orders for its own account before those of customers in identical or better conditions than the latter ("front running").

5.3) POST- EXECUTION OF ORDERS

181. An investment firm must establish internal policies for the proper recording, allocation and distribution of executed transactions.

182. Where orders for own and customers accounts have been aggregated, the investment firm must not allocate the related trades in any way that is detrimental to any customer. If such aggregated orders are only partially executed, allocation to customers must take priority over allocation to the investment firm.

6. INDIVIDUAL DISCRETIONARY PORTFOLIO MANAGEMENT

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

183. 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 certain additional provisions specifying the mandate and periodic reporting, must be signed between the parties.

184. An investment firm must take all reasonable 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.

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ANNEX

CORE PRINCIPLES FOR « COUNTERPARTY RELATIONSHIPS »

The « **counterparties regime** » [14] consists of the following principles:

- ***The firm must at all times act honestly, fairly and professionally in accordance with the integrity of the market.***
- ***The firm must have and must employ effectively the resources and procedures that are necessary for the proper performance of its business activities.***
- ***The firm must establish an independent compliance function, aimed at ensuring that its directors, partners, employees and agents behave in accordance with the integrity of the market.***
- ***Executive directors/senior management must take reasonable measures to ensure that the firm establishes and implements adequate compliance policies and procedures.***
- ***The firm must be able to demonstrate that it has acted in compliance with standards of market integrity and that its organisation, policies and procedures facilitate such compliance.***
- ***The firm must adopt and take all reasonable steps to ensure compliance with an appropriate internal code of conduct***
- ***The information provided in a marketing communications must be clear and not misleading.***

[14] A « counterparty relationship » is characterized by the absence of a client relationship (i.e. without any provision of service), typical of market participants directly active in the market for their own account. This exemption may be applied to transactions executed by some entities which are active on own account in financial markets, in particular:

- inter-dealer transactions executed among authorized investment firms (including non-ISD firms, such as commodity dealers on derivatives markets) ;
- transactions executed in regulated markets or other organised trading platforms by any member admitted to trade in these markets ;
- transactions executed between authorized investment firms and other entities participating in the market, whose annual sales are not inferior to 2 Billion of Euros. Only those transactions undertaken by these entities for which they are direct counterparty for proprietary trading purposes are liable to operate subject to the counterparty/market participant regime. Other transactions entered into such an entity, and effected through the offices of an authorised intermediary, would be subject to the « professional regime ».

The entities meeting one of the above mentioned criteria and willing to enter into a « counterparty relationship » have to reciprocally confirm in the contract that the transaction is executed under a « counterparty relationship ».
No service being provided to a customer, there is no need for applying conduct of business rules for investor protection purposes.

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IMPLEMENTATION OF ARTICLE 11 OF THE ISD: CATEGORISATION OF INVESTORS FOR THE PURPOSE OF CONDUCT OF BUSINESS RULES

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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 CESR, 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 CESR, 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 CESR 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.

6. CESR 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 CESR 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 CESR 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 CESR is designed to give investment firms clear and reliable guidance while protecting the interests of investors.

8. The members of CESR recognise that the implementation of the definition of professional investor is inevitably linked to the contents of the relevant rules of conduct. The scope of this paper is nonetheless limited to the criteria that should be used to categorise investors as professionals.

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 CESR 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 (15)
- Investment firms (16)
- Other authorised or regulated financial institutions (17)
- Insurance companies (18)
- Collective investment schemes and management companies of such schemes
- Pension funds and management companies of such funds
- Commodity dealers.

b) Large companies and other institutional investors:

- issuers of listed financial instruments, i.e. entities whose securities (equity instruments or other) are traded on a regulated market (19);

- large companies and partnerships meeting two of the following size requirements (20):

- balance sheet total : EUR 12.500.000,
- net turnover : EUR 25.000.000,
- average number of employees during the financial year : 250.

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(15) Within the meaning of Article 1 of Directive 2000/12/EC: "*Credit Institution shall mean an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.*"

(16) 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."*

(17) Within the meaning of article 1(5) of Directive 2000/12/EC.

(18) 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.

(19) Within the meaning of article 1.13 of the ISD.

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

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- Other institutional investors whose corporate purpose is to invest in financial instruments.

c) National and regional 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

12. The members of CESR consider that investors other than those mentioned in § 10, including public sector bodies [21] and private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules.

    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 categories listed in §10.

13. 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.

14. 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 [22] exceeds 0,5 million Euro;

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(21) 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.

(22) Within the meaning of Section B of the Annex of the ISD.

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- 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.

II.2 Procedure

15. The 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.

16. 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.

17. 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