COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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FEEDBACK STATEMENT

CESR Technical Advice to the European Commission in the context of the MiFID Review – Client categorisation

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I. Introduction

1. In a letter to the European Commission (Commission) dated 19 March 2010[1], CESR said that its response to some of the Commission's questions (which were set out in a letter from the Commission in March 2010[2]) concerning the review of the Markets in Financial Instruments Directive 2004/39/EC (MiFID) might be delayed because of the need to consult.

2. CESR consulted on its response to Question 19 (on client categorisation) of the Commission's questions because it raised significant policy issues, including some which go beyond the confines of the question asked, on which it was necessary to have stakeholders' comments before responding.

3. In this Feedback Statement, CESR summarises and comments on the responses received to its Consultation Paper (CP) "CESR Technical Advice to the European Commission in the context of the MiFID Review – Client Categorisation" (Ref. CESR/10-831). The CP was published on 12 July 2010, and the consultation period closed on 9 August 2010.

4. CESR received 43 responses (9 of which were confidential). CESR is grateful to all respondents for taking the time to give CESR their views within a shortened timeframe. A list of all non-confidential respondents can be found in Annex I, and their responses can be read on CESR's website.

5. This paper should be read in conjunction with CESR's Technical Advice (Ref. CESR/10-1040) which was published in October 2010. CESR's Technical Advice did not set out drafting proposals for legislative changes to the MiFID Level 1 or Level 2 Directives. It set out for the Commission a suggested policy approach for its review of the MiFID client categorisation regime.

Executive summary

Overall, respondents to the CP (Ref. CESR/10-831) felt that the current MiFID rules on the categories of clients, and the obligations attaching to each, are generally appropriate and do not need changing. Several respondents specifically stated their strong concerns about the possibility of the client categorisation regime being subject to amendment.

As set out in its Technical Advice on client categorisation (Ref. CESR/10-1040), CESR agrees with the majority of respondents that the client categorisation regime does not require significant change. While supporting the Commission's initiative to review MiFID, in order to adapt current provisions to recent developments of the financial and capital markets, most respondents said that MiFID's client categorisation regime is largely working well. In the context of the wider MiFID review, this majority respondent view indicates that the client categorisation regime does not need radical review.

Most respondents commented that the current tiered client categorisation regime already largely reflects an appropriate balance to provide adequate investor protection to retail and professional clients, and that as MiFID already allows clients to opt down at any time, those who are not comfortable with their classification can, and do, request additional regulatory protection. Many respondents pointed out that this is an important safety feature already built into the process and that it should not be overlooked by the Commission in proposing any changes to the client categorisation regime.

[1] Ref. CESR/10-359 - http://www.cesr-eu.org/popup2.php?id=6575

[2] http://www.cesr.eu/index.php?page=document_details&id=6573

Respondents pointed out that the anecdotal evidence suggests that the regime is working well: that is, there has been no significant increase since MiFID implementation in customer complaints about mis-classification; there are very few issues on this subject that have been posted on the Q&A section of the Commission's website - which possibly reflects the fact that the current regime is well understood by market participants; and there are no widespread practical problems in the day-to-day business of industry players that would make significant change necessary.

While agreeing that per se professional clients (MiFID Annex II.I) and eligible counterparties (ECPs) (MiFID Article 24) include entities presenting differences in their nature, their size and the complexity of their businesses, a few respondents pointed out, and CESR agrees, that these differences do not necessarily suggest differences in their respective capabilities to properly assess the risks of the financial markets in which they participate or in asking for more protection where they have doubts. In setting criteria, there is a risk that those that should be included have been left out, and vice versa. But many respondents considered that the current flexible regime strikes the right balance on this front. Also, there is little evidence that the current criteria are perceived by clients as being set too low, as there are not significant numbers of clients requesting greater levels of regulatory protection.

In spite of the majority opposition by respondents to major amendments to the regime, most respondents supported clarifications to the relevant definitions and terms in MiFID where there may be some ambiguity (for example, "locals" and/or "other institutional investors"). As set out in its Technical Advice (Ref. CESR/10-1040), CESR does not rule out the possibility of future work at Level 3 to provide guidance or explanations as to what some terms mean in this context.

In the same vein, many respondents considered (and CESR agrees) that it would be helpful to clarify that local authorities do not fall within the scope of "public bodies that manage public debt"; and that, when dealing with ECPs, investment firms have to (i) act honestly, fairly and professionally, and (ii) communicate with ECPs in a way that is fair, clear and not misleading (especially as these standards are consistent with the way in which firms already seek to act in the marketplace).

On the issue of costs and benefits, many respondents pointed out that the current client categorisation regime was implemented (fairly recently) at great cost to the industry. In the absence of any widespread market failure, and against the background of a principle-based regime that already allows for the customised treatment of different advice or selling situations and the accumulated experience with this regime so far, and without any persuasive evidence to the contrary, many respondents considered that there are no grounds that may justify a revision of the client categorisation rules.

Client categorisation is part of a larger system of investor protection that consists also, amongst other rules, of suitability and appropriateness tests for certain services; client information rules; and fitness and propriety tests for prospective directors. Some respondents said that the intention of the client categorisation regime is not to regulate the sale of investment products. These respondents suggested that evidence of mis-selling to per se professional investors is limited to specific sectors and products, and that, therefore, any change in the client categorisation rules should be seen in this context and in the context of the present system that, generally speaking, works well. Many respondents requested that the Commission take into account the fact that any attempt to address the perceived problem by altering the current regime is likely to have another large, and perhaps disproportionate, cost impact on firms (for example, as a result of changes to client take-on procedures, business practices and record-keeping systems).

II. Overview of respondents' comments

General comments

6. Overall, the vast majority of respondents felt that the current MiFID rules on the categories of clients, and the obligations attaching to each, are generally appropriate and do not need changing – and certainly not on a major scale. Several respondents specifically stated their strong concerns about the possibility of these rules being amended (which was particularly focused around the costs of reviewing clients' categorisation and of communicating with them about changes).

7. While supporting the Commission's initiative to review MiFID, in the context of recent developments in the financial and capital markets, most respondents said that MiFID's client categorisation regime is largely working well.

8. Most respondents commented that the current client categorisation regime already largely reflects an appropriate balance, and is flexible enough, to provide adequate investor protection to retail and professional clients. As MiFID already allows clients to opt down at any time, those that do not feel comfortable with their classification can request additional regulatory protection. Respondents said that this is an important safety feature already built into the process and should not be overlooked by the Commission in making any changes to the regime.

9. While agreeing that per se professional clients (Annex II.I of MiFID) and eligible counterparties (Article 24 MiFID) include entities presenting differences in their nature, their size and the complexity of their businesses, a few respondents pointed out, and CESR agrees, that these differences do not necessarily suggest differences in their respective capabilities to properly assess the risks of the financial markets in which they participate or in asking for more protection where they have doubts. In setting any criteria, there is a risk that those that should have been included have been left out, and vice versa. But many respondents considered that the current regime strikes the right balance on this front, so more widespread use of knowledge tests or further distinctions between the regulated entities, as described in Annex II.I, are not warranted. Also, there is little evidence that the current threshold is perceived by clients as being set too low as there are not significant numbers of clients requesting greater levels of regulatory protection.

10. Many respondents felt that there is no need to narrow the scope of the current categories to give greater investor protection for non-retail clients. Respondents, therefore, generally considered that the suggested amendments, including restrictions on the range of entities that are considered to be per se professionals or the narrowing of the range of entities, are not necessary or practical for either investment firms or clients; and that they would not provide additional protection.

11. Respondents indicated that clients that do not want to be treated as retail clients are likely to oppose further investor protection requirements for investment firms. Therefore, investment firms should not apply knowledge and experience tests to these clients. Placing further obligations on investment firms to assess existing per se professional clients' knowledge, experience and expertise is unnecessary. It is likely to create an unjustified burden and cost for investment firms and their clients, especially as firms falling within Annex II.I(1) of MiFID will have already had to demonstrate to their regulator or authorising body that they have the necessary knowledge, experience and expertise to operate in the financial markets, and are able to identify and manage the risks to which their businesses are subject.

12. Some respondents suggested that local authorities and large undertakings ought already to have in place governance structures and operational systems and controls which enable them to determine not only their investment needs and strategies, but also the necessary practical limits of their investment competence. Some respondents felt that requiring firms to assess the

knowledge and experience of professional clients on an individual basis would be no substitute for such entities instituting their own controls and ensuring that such controls are rigorously applied, monitored and adapted for changing circumstances.

13. In spite of the above majority opposition to major amendments to the regime, most respondents supported some clarification to the definitions and/or terms in MiFID where there may be some ambiguity.

Specific points raised by respondents

New terminology: "very complex", "highly complex", "super ECP"

14. Many respondents raised concerns that the language in the CP included terms such as: "very complex", "highly complex" and "potentially complex" – as a way of elaborating the relative complexity of different financial instruments. The concern was that complexity is almost impossible to define in a way that is appropriate to the circumstances of all clients, or even all clients within a particular category. Some respondents feared that the introduction of criteria to distinguish between "complex" and "highly complex" products is likely to be misleading, will create legal uncertainty, and is not relevant in light of structural differences between asset classes. MiFID itself only distinguishes between complex and non-complex for the purposes of the appropriateness test. Providing the client has the appropriate knowledge and expertise, or uses the services of specialist advisers, there should be no requirement to further classify such products.

15. These respondents also pointed out that it has been difficult and costly for a reasonably common understanding to be reached on the divide between complex and non-complex products for the purposes of the retail client-driven appropriateness test. So, seeking to define further levels of complexity that interact dynamically with different client categories would not only be a complicated and costly exercise, but might also result in basic regulatory protections being applied in an inconsistent way to clients who are fundamentally alike in many respects.

16. While appreciating that complex products create additional challenges for investors in terms of assessing the investment decision and the risks involved, most respondents thought that an additional "super eligible counterparty" regime, or further rules, are not necessary to address complex products. Professional clients should still be able to assess these products, either themselves or through acquiring relevant expertise, and to make appropriate investment decisions, as long as they are receiving the required information and disclosures about the investment services and financial instruments.

Cost-benefit

17. Many respondents stated that the current tiered approach to client categorisation (only implemented three years ago) provides a proportionate and adequate system of investor protection, and was implemented at great cost to the industry. They argued that evidence of alleged mis-selling of products to per se professional investors is limited and should be measured against the background of all transactions. Respondents noted, and CESR agrees, that any changes the Commission deems necessary ought to be targeted specifically at problem sectors and financial instruments to ensure that the benefits outweigh the costs.

18. So any attempt to address the perceived problem (the size and significance of which have not been identified clearly enough) by altering the current regime is likely to have another big cost impact on firms. For example, it would require changes to client take-on procedures, business practices and record-keeping systems – disproportionate to the perceived problem; and the reassessment of, and reissuing of documentation to, clients would be unduly burdensome. Given all this, some respondents pointed out that the allocation of resource to a potentially major re-categorisation exercise would greatly exceed the benefits that would flow from such an exercise.

19. Respondents variously noted that the anecdotal evidence suggests the regime is working well: that is, there is no significant increase since MiFID implementation in customer complaints about mis-classification; very few issues on this topic have been posted on the Q&A section of the Commission's website, which possibly reflects the fact that the current regime is well understood by market participants; and there are no widespread practical problems in the day-to-day business of the industry that would make significant change necessary.

20. Other respondents stated that to introduce a further assessment into the per se professional client category would create an unwieldy, costly and unnecessary step in agreeing to provide investment services.

21. In the absence of widespread market failure and against the background of a principle-based regime that allows for a customised treatment of different advice or selling situations and the accumulated experience with this regime so far, and without any persuasive evidence to the contrary, many respondents considered, and CESR agrees, that there are no grounds that may justify a significant revision of the client categorisation rules. Categorisation is part of a larger system of investor protection, consisting also, amongst other rules, of suitability and appropriate tests for certain services; client information rules; and fitness and propriety tests for prospective directors. Any change in the categorisation rules should be seen in this context and in the context of the present system that, generally speaking, works well.

Short consultation period

22. A few respondents (5) made the general point about the short timeframe provided for responding to this consultation paper, expressing their concern about this given the importance of the client categorisation regime.

23. In setting this timeframe, CESR was constrained by the timing of the Commission's request and by the Commission's decision to consult on the MiFID review in the last quarter of this year. So, given the need to respond to the Commission by the end of September 2010, CESR could not follow normal consultation practices by allowing the usual eight to twelve weeks for respondents to contribute.

III. Part 1: Technical criteria to further distinguish within the current broad categories of clients

24. MiFID Annex II.I sets out clients that are considered to be professionals (termed "per se" professionals to distinguish them from clients who opt, or request, to be professionals under MiFID Annex II.II). Part I of Annex II ("Categories of client who are considered to be professionals") is divided into four sections, the first of which deals with entities "authorised or regulated to operate in the financial markets".

25. In its CP (Ref. CESR/10-831), CESR asked the following questions:

1. **Do you agree that the opening sentence of Annex II.I(1) sets the scope of this provision and that points (a) to (i) are just examples of "Entities which are required to be authorised or regulated to operate in financial markets"?**
2. **Do you think there is a case for narrowing the range of entities covered by points (c), (h) and (i) of Annex II.I(1)? Please give reasons for your response?**
3. **If you believe there is a case for narrowing the range of entities covered by points (c), (h) and (i) of Annex II.I(1) what criteria do you think should be used to distinguish between those entities that are covered and those that are not?**
4. **Do you believe there is a need to clarify the language in points (c), (h) and (i) of Annex II.I(1) and, if you do, how do you think the language should be clarified?**

Scope of Annex II.I(1)

26. Nearly all respondents agreed with CESR that the opening sentence of MiFID Annex II.I(1) sets the scope of that provision and that points (a) to (i) are just examples (that is, are not meant to be taken as an exhaustive list) of "Entities which are required to be authorised or regulated to operate in financial markets".

Narrowing the range of entities in (c), (h) and (i)

27. Most respondents stated that they do not believe there is a case for narrowing the range of entities in points (c), (h) and (i)[3] that are deemed to be per se professional clients - not least because no evidence has been provided that the current definition is deficient, or that the entities in question have suffered detriment as a result of being per se professional clients, or that MiFID has failed, or that the criteria set out in Annex II.I have led to any serious cases of mis-selling or large-scale fraudulent activity when dealing with clients in the wholesale markets.

28. A few respondents noted that if it is true that some regulated entities, in some situations, do not have the knowledge and expertise to make their own investment decisions and properly assess the risks they incur, then, assuming they are acting within the scope of their authorisation (i.e. their competency, and that of their employees, has already been established), any failings would lie with their Home States' authorisation processes, as well as with the competence of the individual firms - and not with Annex II.I(1) of MiFID.

29. Some respondents pointed out that the entities included in points (c), (h) and (i) are all actively engaged in the capital markets, are either authorised or regulated in those activities, and are conversant with the current MiFID rules, including those rules that permit such entities to request treatment as "non-professional". They should be competent with regard to financial instruments and markets, and other market participants should be entitled to assume that this

[3] Respectively: 'other authorised or regulated financial institutions'; 'locals'; and 'other institutional investors'.

is the case. Notwithstanding this, authorised and/or regulated firms that are considered to be professional clients, but do not feel competent to enter into certain transactions, already have the responsibility to request higher levels of client protection as stated in Annex II.I: "*It is the responsibility of the client considered to be a professional client, to ask for a higher level of protection when it deems it is unable to properly assess or manage the risks involved*".

30. Per se professional clients covered by point (1) of Annex II.I are already narrowed down to entities authorised or regulated to operate in financial markets. They will have had to demonstrate to their regulator or authorising body that they have the necessary knowledge, experience and expertise to operate in the financial markets, and are able to identify and manage the risks to which their businesses are subject. It is reasonable, therefore, to assume that such entities can be treated as per se professional clients. Such firms will, in the vast majority of cases, have sufficient knowledge to properly assess the risk of the product or service being offered to them or, in the minority of cases where they do not, the ability to identify that they do not have the necessary knowledge - in which case they can either acquire that knowledge from an outside source or, as Annex II.I itself notes, request to be treated as a retail client (or, of course, decide not to proceed).

31. One respondent said that the clarifications that CESR suggests are not likely to significantly narrow the scope of the entities included within those points (c), (h) and (i).

32. Another respondent noted that recent experience (the global banking crisis) has demonstrated that some entities identified by the standard MiFID criteria to be per se professional clients have, indeed, lacked the financial knowledge and expertise anticipated for organisations operating in the investment sector; and that this situation is likely to be exacerbated by the development of products of ever increasing complexity in the future.

33. Many respondents supported the suggestion that points (c), (h) and (i) could be improved through definitional clarity to remove any doubt about the types of entities included within the scope of the current terms; provided that this does not narrow down the range of entities covered. A number of respondents pointed out that narrowing down the range of entities covered by points (c), (h) and (i) would mean that there would be authorised entities assumed not to have the necessary knowledge and experience to be categorised as per se professionals.

34. Some respondents stated that any narrowing of definitions of the various categories in Annex II.I is likely to lead to legal uncertainty, which is neither in the interests of clients nor in the interests of investment firms. In addition, one respondent pointed out that changes as suggested may exempt entities outside the European Economic Area (EEA) from being considered per se professional clients; and that would create an unlevel playing field to the disadvantage of European entities, as they would be obliged to treat certain foreign entities as retail clients – in spite of the fact that those entities are likely to have enough resources to understand investment products or to realise the limits of their knowledge in which case they can ask to be treated as retail clients.

35. One respondent stated that any problem of mis-selling ought to be tackled at a transactional level by altering the application of the suitability and appropriateness tests, and not with a change to the client categorisation regime.

Clarifying the language in (c), (h) and (i)

36. A few respondents said that given the similarity in terminology used for entity type Annex II.I(1)(i) "Other institutional investors" and entity type Annex II.I(4) that is also eligible for treatment as a per se professional ["Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions"], further clarification to distinguish between these two entity categories would be beneficial.

37. The majority of respondents stated that the language in (c), (h), and (i) does not need to be clarified, especially as MiFID appears to be achieving its objectives and the current wording provides sufficient guidance as to the classification of customers. However, some of these same respondents stated that additional clarification within the range of entities would benefit firms and their clients (for instance, by providing more examples within each entity type) and would be welcomed as long as it does not lead to any narrowing of the range of entities included in the category of per se professional clients. This would provide more certainty on the intended coverage and remove any doubt about entities included within the scope of the current terms.

CESR's response: CESR is pleased to note that a significant majority of respondents agreed with its opinion that the scope of MiFID Annex II.I(1) is set by the opening sentence of that provision, and that points (a) to (i) are just examples (that is, are not meant to be taken as an exhaustive list) of "Entities which are required to be authorised or regulated to operate in financial markets".

As set out in its Technical Advice (Ref. CESR/10-1040), CESR notes that no case has been made for narrowing the range of authorised or regulated entities that are deemed to be per se professional clients - not least because no evidence has been provided that the current definition is deficient, or that the entities in question have suffered detriment as a result of being per se professional clients, or that MiFID has failed, or that the criteria set out in Annex II.I(1) have led to serious cases of mis-selling in the wholesale markets.

CESR agrees with the majority of respondents that the language does not necessarily need to be clarified, especially as MiFID appears to be achieving its objectives and the current wording provides sufficient guidance as to the classification of customers. However, CESR believes – and many respondents supported - that additional clarification within the range of entities could possibly benefit firms and their clients (for instance, by providing more examples within each entity type) - as long as it does not lead to any narrowing of the range of entities included in the category of per se professional clients. Additional definitional and explanatory text could help to clarify the language in points (h) and (i); and this would provide more certainty on the intended coverage and remove any doubt about entities included within the scope of the current terms.

But, rather than amending the legal text, CESR suggests that in order to encourage a consistent understanding of the coverage of Annex II.I in the market, it may be more appropriate (in terms of clarifying language), and would certainly be helpful, to set out some typical examples and their appropriate treatment on the Q&A section of the Commission's website or through CESR's own Q&A.

IV. Part 2: Public debt bodies

38. There is no definition of what constitutes a public debt body in MiFID Article 4 ("Definitions"); and yet there are references to public debt bodies in MiFID Annex II.I(3) (in relation to clients that are considered to be professionals), and in MiFID Article 24(2) (in relation to undertakings that are considered to be eligible counterparties).

39. In the CP, CESR asked:

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

40. A number of respondents stated that they were not aware of any practical problems in this regard. Nevertheless, the majority of respondents agreed with CESR that clarification was required to confirm whether the term "public bodies that manage public debt" includes local authorities; and supported the view that local authorities and municipalities should be specifically excluded from the definitions of entities in Annex II.I(3).

41. Some respondents considered that Member States should define "public bodies" and state whether the definition includes 'local authorities'. Others stated that a definition of a 'local authority' would be useful, as this currently encompasses very different entities depending on the Member State involved. However, it is because of the differences in local legislation pertaining to the financial market activities of local authorities across Europe that CESR suggests that a change to MiFID alone is unlikely to achieve the consistency and clarity that is desired.

42. One respondent said that it would welcome clarification on whether local authorities, including municipalities, are classified as per se professional clients since they are responsible for their own budget and therefore usually have the necessary financial knowledge and experience. Another respondent stated that in its Member State, all institutions related to the public deficit/debt are linked to public institutions and would systematically be classified as "professional clients" or "eligible counterparties". Several UK respondents considered that the domestic legislation, associated regulations and professional codes set out for UK local authorities may make these entities distinct from other local authorities in Europe and stated they would welcome further clarity.

43. A few respondents did not support the CESR view that public bodies managing public debt should exclude local authorities.

44. One respondent stated that professional investors are sufficiently protected by the regulatory regime, as Annex II.I(4) provides local authorities several options enabling them to request a higher level of protection, even treatment as "non-professional". Local authorities and the investment firm may agree on a reclassification according to which the local authority is to be treated as a non-professional investor.

45. A number of respondents asked that when CESR is considering the proposals for the client classification, CESR provides sufficient flexibility for local authorities to continue using the limited range of products and services to which they currently have access. In particular, one respondent stated that if CESR proposes that local authorities are not to be included within the definition of public debt bodies, then local authorities should be retained within the list of per se professional clients – if not, they will be deemed to be retail clients and their access to wholesale money markets and counterparties will be limited, which will unnecessarily disadvantage them.

CESR's response: CESR agrees with many respondents that there are significant differences in national legislation pertaining to local authorities across Europe – so much so that a change to MiFID alone is very unlikely to achieve the consistency and clarity sought.

However, as set out in its Technical Advice (Ref. CESR/10-1040), CESR believes that there is a case for clarifying the scope of Annex II.I(3) to make it clear that local authorities do not fall within the scope of "public bodies that manage public debt".

V. Part 3: Other client categorisation issues

46. The purpose of the client categorisation regime is to tailor client protections in the light of clients' ability to make their own investment decisions and understand the risks involved. Inevitably it does this in a broad brush way. For entities that are considered to be per se professional clients or per se eligible counterparties there is no specific test of their ability to make their own investment decisions and understand the risks involved. The categorisation also does not look through to the specific transactions a client is undertaking, although a client can opt for a higher level of protection in relation to specific transactions.

47. This general broad brush approach could potentially mean that there are some clients considered to be professional clients or eligible counterparties who do not in fact have the knowledge and experience implied by their categorisation either generally or in relation to certain financial instruments.

48. In the CP, CESR asked the following questions:

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

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

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

9. If you believe the rules should be changed:
- **for what products should they be changed; and**
- **which of the approaches to change set out in the paper would you favour?**

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

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

Assessment of knowledge and experience

49. The overwhelming majority of respondents stated that they did not believe that it is appropriate that investment firms be required to assess the knowledge and experience of at least some currently per se professional entities – with many of these respondents referring to cost-benefit reasons. These respondents stated, amongst other things, that practical experience shows that such professionals have the necessary knowledge and experience.

50. These respondents stated that most entities that currently qualify as per se professional clients (including large undertakings) are frequently engaged in the capital markets, are conversant with the relevant MiFID rules, and engage sophisticated counsel when carrying out investment business. The additional burden implied by applying knowledge and experience tests would be disproportionate and is unlikely to yield any real benefits to such entities, which already avail themselves, when necessary, of the "opt down" provisions in Annex II which provides additional regulatory protection.

51. Further, in the limited circumstances where an entity which is classified as a "per se professional" does not actively engage in the capital markets and begins to do so, the experience of respondents suggests it will almost always engage professional advisers, including law firms, which will be able to advise on the existence of the "opt down" provisions.

52. Although some entities that qualify as per se professional clients under the current rules may indeed have insufficient knowledge and experience to fully assess the risks of transactions they undertake, some respondents noted that there is little evidence that this is a pervasive problem with the current regime, or underlined that there is an issue limited to certain sectors (eg local authorities) which are failing to fully appreciate the risks involved in the transactions that they are entering into. Therefore, some respondents suggested that if any changes are deemed necessary it would be more appropriate to specifically target those problem sectors and financial instruments to ensure that the benefits outweighs the costs.

53. Some firms will inevitably be more knowledgeable than others, but many respondents considered that a single threshold is still preferable to assessing the capabilities of an individual representing the firm.

54. A few respondents pointed out that it is probably practically not possible to apply a test to an entity as a whole because a firm itself does not possess knowledge and experience in a way that an individual does. And applying the test to individuals working in those entities would be equally impractical – staff turnover aside, a single person may not be solely responsible for all aspects of an investment decision. Therefore, the current approach of listing the types of entities that can be considered as per se professional clients, and distinguishing them by size, is the only workable solution, especially considering their ability to seek re-classification.

55. Some respondents noted that authorised and regulated firms, and their staff, have to be competent to carry on investments within the scope of their authorisation, and the supervision and enforcement of this is the responsibility of the regulator. Furthermore, the knowledge and experience required for authorisation should be deemed sufficient to responsibly choose higher levels of protection, by opting down to retail client status, when necessary. With this in mind, additional knowledge and experience tests would be an overly bureaucratic and burdensome requirement.

56. Furthermore, a few other respondents said that it is likely that professional clients themselves would find it inappropriate, unnecessary and cumbersome to deal with the investment firms obtaining further information from them to assess knowledge and experience.

57. It would be unnecessary to incorporate requirements for investment firms to assess the knowledge and experience of these entities where, in the overwhelming majority of cases, the result would be the same as if no such assessment had been required. The cost and effort of carrying out and maintaining records of such assessments for what is likely to be a small subset of per se professional clients appears to be a disproportionate and unnecessary burden, far outweighing the possible benefits of doing so.

58. Assessing knowledge and experience would require an investment firm to assess: the types of service, transaction and designated investments with which the client is familiar; the nature, volume, frequency of the client's investment history; and the level of education, profession or relevant former profession of the client. This information would be difficult to assess (and maintain) for corporate and large clients, even if this just related to "complex" investments, such as OTC derivatives. And, if the assessment was only required in relation to certain instruments this may cause confusion around when such assessments need be made. There would be significant costs involved in IT systems updates and training costs. Investment firms may need to repaper existing relationships and re-assess suitability for all clients that are currently "per se professional clients". This would be time-consuming and require extensive resources – a costly measure with no guarantee that misunderstandings or miscalculations in taking on risk would be eliminated.

59. Additional information requests would make the take-on process more lengthy and costly for all parties, and may discourage competition by deterring potential customers from using more than

one financial services provider. These and other costs to the industry should be considered in light of the benefits before changing the current regime.

OTC derivatives and other complex products

60. The majority of respondents did not believe that client categorisation rules need to be changed in relation to OTC derivatives and other complex products – especially as firms can request re-classification if they decide that they are unable to make an informed decision about certain products.

61. Legal uncertainty aside, many of these respondents also noted that an exhaustive list of what constitutes "OTC derivatives and other complex products" would be almost impossible (let alone disproportionate) to create in any meaningful way; but also that if there is no (meaningful) clarity as to which products are caught (and given the pace of product innovation, any list would soon become outdated), then it would be very difficult to implement these rules in practice.

62. A few respondents also claimed that the client categorisation regime was never intended to regulate the sale of investment products and that any solution that may be necessary is available through consistent and active supervision and enforcement of the existing requirements by competent authorities, rather than by changes to the MiFID client classification rules – which, in any event, were not designed to prevent, or protect against, misrepresentation or fraud. These respondents noted that it may be a more proportionate response to encourage competent authorities to focus on the supervision and enforcement of the MiFID Article 19 conduct of business obligations.

63. CESR believes that the client categorisation regime is a part of - and not separate from - MiFID's regime governing the selling of financial instruments. It does not believe that it is correct to suggest that the MiFID conduct rules do not have anything to do with preventing misrepresentation or fraud, although obviously the wider legal framework, including the criminal law, will also be relevant for such offences. CESR agrees that it is important for its members to concentrate on supervising compliance with the obligations in Article 19 of MiFID and welcomes support from industry for a more intrusive approach to enforcing these obligations.

Clarifying standards that apply when transacting with ECPs

64. On clarifying the standards that apply to transactions with an ECP, many of the respondents that addressed this point specifically did not think that this was necessary, but nevertheless agreed with CESR that it would be reasonable to clarify that, for market transparency and integrity purposes, in dealing with an ECP investment firms have to act honestly, fairly and professionally; and communicate in a way that is fair, clear and not misleading.

CESR's response: As set out in its Technical Advice (Ref. CESR/10-1040), CESR:

- agrees with the majority of respondents that in the absence of a significant problem it is not proportionate to require investment firms to assess the knowledge and experience of what is likely to be only a small number of per se professional clients (including large undertakings);
- agrees with the majority of respondents that the client categorisation rules in relation to OTC derivatives and other complex products do not need to be changed; and that the creation of a "super ECP" status for highly complex products is not appropriate – not only because these concepts are difficult to define, but, more importantly, because any resultant definitions are likely to quickly lose their relevance over time; and
- has suggested, with respondent support, that it could be made clearer that in dealings with ECPs, investment firms, for market transparency and integrity purposes, have to act honestly, fairly and professionally; and communicate in a way that is fair, clear and not misleading.

Annex I: List of non-confidential respondents

Alternative Investment Management Association, UK (AIMA)

Association of British Insurers, UK (ABI)

Association of Danish Mortgage Banks – Realkreditradet, Denmark (RKR)

Association for Financial Markets in Europe (AFME) /International Swaps and Derivatives Association (ISDA) /International Capital Market Association (ICMA) /British Bankers Association (BBA) - joint response, UK

Association Française des Investisseurs Institutionnels, France (Af2i)

Association française des marchés financiers, France (AMAFI)

Association nationale des conseils financiers, France (ANACOFI)

Association of Private Client Investment Managers and Stockbrokers, UK (APCIMS)

Austrian Federal Economic Chamber (Bank and Insurance Division), Austria

British Venture Capital and Private Equity Association (BVCA)

Butlers (Division of ICAP Securities Ltd)

Bundesverband Investment und Asset Management, Germany (BVI)

Capita Group plc, UK

Chartered Institute of Public Finance and Accountancy, UK (CIPFA)

City of London Law Society, UK (CLLS)

CIPFA Scottish Treasury Management Forum, UK

Energy Commodity Traders Group (ECT-Group)

European Association of Co-operative Banks, Brussels (EACB)

European Association of Corporate Treasurers, France (EACT)

European Association of Public Banks, Brussels (EAPB)

European Banking Federation, Brussels (EBF)

European Fund and Asset Management Association, Brussels (EFAMA)

European Savings Banks Group (ESBG)

French Banking Federation - Fédération Bancaire Française, France (FBF)

Futures and Options Association (FOA) /Association of Private Client Investment Managers and Stockbrokers (APCIMS) – joint response, UK

Investment Management Association, UK (IMA)

Italian Association of Financial Intermediaries - Associazione Italiana Intermediari Mobiliari, Italy (ASSOSIM)

Local Government Association, UK (LGA)

Nordic Securities Association (NSA)

State Street Corporation, US

Verband der Auslandsbanken in Deutschland (Association of Foreign Banks in Germany) (VAD)

West Yorkshire Pension Fund, UK

Wholesale Markets Brokers' Association (WMBA) /London Energy Brokers' Association (LEBA) – joint response, UK

Zentraler Kreditausschuss, Germany

9 respondents asked for their responses to remain confidential.