COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Date: 12 July 2010
Ref.: CESR/10-831

CONSULTATION PAPER

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

Deadline for contributions: CESR invites responses to this consultation paper by 9 August **2010**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests its submission to be confidential.

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Executive Summary

In the context of its review of the Markets in Financial Instruments Directive (MiFID), the European Commission (EC) posed a series of questions to CESR. The purpose of this consultation is to gather stakeholders' views on client categorisation issues to assist CESR in its responses to the Commission's questions on these issues.

The main points in this consultation paper are under the following three headings:

Technical criteria to further distinguish within the current broad categories of clients ["other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I(1) (c), (h), (i) of MiFID)]: Part 1 of the consultation paper asks whether distinctions should be made between regulated entities for the purposes of determining which entities are to be treated as "per se" professional clients.

Public debt bodies: Part 2 of the consultation paper asks whether it is necessary to clarify, for the purposes of the client categorisation regime, whether local authorities/municipalities can be treated as public debt bodies.

Other client categorisation issues: Part 3 of the consultation paper asks whether tests of knowledge and experience should be used more widely for client categorisation than is currently the case, whether for very complex products (such as asset backed securities and non-standard OTC derivatives) the scope of the eligible counterparty categorisation should be narrowed and what standards should apply to transactions done with eligible counterparties.

Introduction

1. On 2 March 2010, the European Commission (EC) wrote to CESR[1] concerning the review of the Markets in Financial Instruments Directive 2004/39/EC (MiFID). Across a range of issues this asked for CESR's supervisory experience and for possible new policy approaches. CESR will provide most of its responses to these questions in July 2010. However, in a letter to the EC dated 19 March 2010[2] (Ref. CESR10-359), CESR indicated that its response on some issues might be delayed because of the need to consult.

2. Several of the questions posed by the EC related to the conduct of business rules in MiFID, including questions on the client categorisation regime. CESR has decided that it wants to consult on the responses to the questions on the client categorisation regime because these raise significant policy issues, including some which go beyond the confines of the questions that have been asked, on which it is necessary to have stakeholders' comments before responding.

3. The questions posed on client categorisation were as follows:

   Q19: "Professional clients per se" (Annex II.I of MiFID) and eligible counterparties (Article 24 MiFID) include a number of entities presenting differences in their nature, their size and the complexity of their business (for instance, small and big financial entities providing different types of activities; different categories of "institutional investors", municipalities and other public bodies). In the perspective of further calibrating the treatment of clients:

   Q19 (a): Please share your supervisory experience and data related to problems encountered in the provision of investment services to professional clients or eligible counterparties. This includes any alleged miss-selling which may have involved public local authorities (e.g. municipalities), small and medium undertakings, institutional investors (e.g. pension funds), or small credit institutions. We ask CESR to provide details about the kind of entities and products concerned;

   Q19 (b): Please consider possible technical criteria to further distinguish within the current broad categories of clients ("other authorised or regulated financial institutions", "locals", "other institutional investors" (Annex II.I (1) (c), (h), (i) of MiFID), public bodies managing public debt (see Article 24(2) and Annex II.I (3) of MiFID).

Status of this consultation paper

4. The responses to this consultation paper will help CESR to shape its approach to the questions on client categorisation that it has been asked by the EC. In responding to the questions, CESR will not be making specific drafting suggestions for revisions to MiFID, but intends to provide a suggested policy approach.

Public consultation and timetable

5. CESR invites comments from stakeholders on this consultation paper. A list of the questions of this consultation paper is set out in Annex 1. Respondents can post their comments directly onto CESR's website (www.cesr.eu) in the section 'Consultations'. The consultation closes on 9 August 2010.

6. This consultation paper has been prepared by the Investor Protection and Intermediaries Standing Committee (IPISC) of CESR, chaired by Mr Jean-Paul Servais, Chairman of the CBFA. The rapporteur of the Standing Committee is Sarah Raisin (sraisin@cesr.eu).

[1] http://www.cesr.eu/index.php?docid=6573
[2] http://www.cesr.eu/index.php?docid=6575

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

Introduction and background

7. The client categorisation regime has three categories of client: retail, professional and eligible counterparties. The conduct of business rules in MiFID then apply differentially to each of these categories of clients in order to provide a proportionate and graduated regime of investor protection.

8. Annex II.I of MiFID sets out those persons who are considered to be professionals (clients who may be termed "per se" professionals to distinguish them from clients who opt to be professionals under Annex II.II of MiFID). This part of the annex is divided into four sections the first of which deals with "entities authorised or regulated to operate in the financial markets".

9. The EC has asked CESR to consider possible technical criteria to distinguish within the broad categories of authorised or regulated entities listed in Annex II.I(1) of MiFID.

Issues under discussion

Scope of Annex II.I(1)

10. CESR believes that the scope of Annex II.I(1) of MiFID is set by the opening sentence of its chapeau: "Entities which are required to be authorised or regulated to operate in financial markets." The second sentence and list that follow this opening sentence help in understanding the first sentence, but do not change the scope of the provision. The second sentence explains that the entities covered by the first sentence fall within one of three categories:

    (i) entities authorised by a Member State under a Directive;

    (ii) entities regulated or authorised by a Member State without reference to a Directive; and

    (iii) entities authorised or regulated by a non-Member State.

11. Therefore, the entities that fall under points (c), (h) and (i) of Annex II.I(1) of MiFID are sub-divisions of the entities who are within the scope of the opening sentence of the chapeau and fit into one of the three categories above. CESR believes that the wording of the points (a) to (i) does not change the scope of the entities who are considered to be professional clients by virtue of this limb of the definition of per se professional clients.

12. It follows from what CESR has said above that if criteria were going to be used to distinguish between entities covered by points (c), (h) and (i), it would be necessary to modify the language in the chapeau so that the wording used in the points listed influenced the scope of the provision.

Interpretation of points (c), (h) and (i) of Annex II.I(1) of MiFID

13. Below are some observations on how the language in points (c), (h) and (i) might be interpreted as it stands.

14. **Point (c).** "financial institution" is a term defined in Article 4(5) of Directive 2006/48/EC as:

    "…an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I".

15. Following this definition would mean that "other authorised or regulated financial institutions" included entities not covered by the Capital Requirements Directive (CRD) or MiFID who meet the definition given above (principally banking and investment entities regulated outside the EEA). However, given that the text of MiFID does not reference the above definition then the term has to stand alone (although using the CRD definition of a financial institution is probably a good starting point for thinking about what this term currently includes).

16. **Point (h).** MiFID does not define the term "locals". However, CESR understands the term as covering the sorts of entities, where they are subject to authorisation or regulation, described in Article 2(1)(l): "firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets".

17. **Point (i). "**Other institutional investors" in Annex II.I(1)(i) is presumably intended to cover institutional investors not covered under points (d), (e) and (f). In contrast to the language used in Annex II.I(4), there is no specific reference to the investors investing in financial instruments as their main activity. However, one would expect the concept of institutional investors in a MiFID context to be mainly focused on investing in financial instruments.

Possible changes to Annex II.I(1)

18. The motivation for revising Annex II.I(1) would be to strengthen investor protection by narrowing the range of regulated entities who can qualify to be treated as clients who are considered to be professionals. This implies that there are some regulated entities who, in some situations, do not have the knowledge and expertise to make their own investment decisions and properly assess the risks they incur. To introduce criteria to distinguish between entities covered by points (c), (h) and (i) would require a revision to the text of Annex II.I(1) so that the points help to set the scope. In these circumstances possible criteria for distinguishing between entities covered by these points might include:

    - whether the entity was regulated or authorised in a jurisdiction with an equivalent regulatory regime to the EU;
    - whether the entity was conducting business on behalf of underlying clients or not; and
    - for points (c) and (i) the size of the entity.

19. In terms of the language of the points in circumstances where they set the scope of the Annex II.I(1) then possible clarifications might include:

    - making a link to the CRD definition of a financial institution in point (c);
    - using wording from Article 2(1)(l) of MiFID to help define a "local" in point (h); and
    - making clear that "other institutional investors" in point (i) covers entities whose main activity is investing in financial instruments.[3]

[3] In Annex II.I(1)(i), "other institutional investors" have to be authorised; in Annex II.I(4) they do not.

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?

Part 2: Public debt bodies

Introduction and background

20. There are references to public debt bodies in Annex II.I of MiFID in relation to clients who are considered to be professionals, and in Article 24 of MiFID regarding undertakings who are considered to be eligible counterparties. There is no definition of what constitutes a public debt body in Article 4 of MiFID (which contains definitions of terms in the Directive).

21. The EC has asked CESR whether there should be technical criteria to distinguish between public debt bodies. Based on the chapeau to the Commission's questions, CESR understands that the EC has particular concerns about how these terms might affect the categorisation of local authorities and municipalities (both sorts of bodies are referred to below as "local authorities").

Issues for discussion

22. There is a difference between the wording used in Article 24(2) of MiFID and Annex II.I (3) regarding public debt bodies. In Article 24(2) the reference is to "public bodies that deal with public debt" but is given in the context of the phrase "national governments and their corresponding offices". In Annex II.I (3) the reference is to "public bodies that manage public debt" and there is no qualification about such bodies being a corresponding office of national government.

23. This difference in language means that the words in Annex II.I (3) are potentially wider than those in Article 24(2). In some Member States local authorities have been classified as per se professional clients under this provision, whilst in most others they have not because it has been assumed that the reference is to standalone bodies managing public debt.

24. A response on the Commission's MiFID Q&A database regarding the classification of non-national layers of government, response ID 249[4], makes clear that "regional governments" in Annex II.I(3) should be interpreted narrowly. It then goes on to say that: "Public sector bodies which are not regional governments and do not manage public debt may be treated as professional clients on request if the conditions in Annex II, Part II are met."

25. This could be taken as implying that a local authority which manages public debt is a client who is considered to be a professional. In at least one Member State, local authorities are able to be treated as clients who are considered to be per se professionals under Annex II.I(3).

26. The ability of local authorities to engage in financial markets also varies from Member State to Member State under laws and rules governing the activities of local authorities. In some Member States local authorities are, for example, prohibited from entering into derivatives transactions.

27. In the light of the above, CESR believes there is a case for clarifying the scope of Annex II.I(3) to make clear that they do not fall within the scope of public bodies that manage public debt.

[4] http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=249

Question

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?

Part 3: Other client categorisation issues

Introduction and background

28. 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.[5]

29. The broad brush approach taken by the client categorisation regime 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. There are three issues about the existing client categorisation regime that CESR believes merit further discussion:

- First, whether there should be more use of tests of a potential client's knowledge and experience in the client categorisation regime.
- Second, how the client categorisation regime works in relation to very complex products.
- Third, the standards that apply when business is done with eligible counterparties (ECPs).

Issues for discussion

Knowledge and experience

30. Under Annex II.I of MiFID covering the clients who are considered to be per se professionals there are no explicit tests of the knowledge and experience of these clients. By virtue of the sort of business they do or their size, entities are deemed to possess the knowledge and experience to make their own investment decisions.

31. As set out above, this broad brush approach to client categorisation might mean that some clients do not get the protections they need because they might not have the knowledge and experience to enable them to properly assess the risks of the transactions they undertake. One way of moving away from such a broad brush approach would be to require investment firms to assess the knowledge and experience of more clients before they could be considered to be professionals. This might be particularly important in relation to unregulated undertakings who currently qualify to be considered as professionals simply by virtue of their size.

Complex products

32. In addition to the numerous weaknesses in the process of securitisation that have been painfully highlighted by the crisis and from which many institutional investors worldwide (and their underlying retail clients) have suffered, a number of cases of alleged mis-selling of complex derivative products to local authorities in Europe have been brought to public attention by the press. Moreover, anecdotal evidence suggests that corporate clients have also fallen victim to similar practices in the marketing of complex derivatives. In the US, local authorities have lost considerable sums in purported "hedging" transactions, several enquiries are underway into whether investment firms have misled institutional investors in complex securities (ABS, ARS), and one case of civil fraud has recently been brought by the

[5] Refer to MiFID Article 24 for the scope of eligible counterparty business.

SEC against a major investment bank involved in the structuring and sale of CDOs to large institutions.

33. These cases appear to show that clients presumed to be sophisticated and capable of looking after their own interests do not always understand the risks involved in complex instruments. They also appear to show that serious failings by investment firms (inadequate disclosures, unsuitable products) occur in the professional markets for some OTC derivatives and certain other complex products. This is not surprising given the considerable information asymmetries and conflicts of interest in these markets, not to mention the profitability of such complex products for investment firms.

34. However, some clients do need to use potentially complex OTC derivatives in order to hedge precisely the specific and bespoke financial risks they may otherwise face. The risk management practices of those clients may be robust and the hedging activity undertaken should bring benefits in overall risk reduction. Any change in client categorisation should neither discourage nor impede that risk management activity.

35. The relationship between intermediaries and clients asking for financial instruments suitable for their hedging needs will likely amount to investment advice since it will include the provision of personal recommendations from the intermediary. In this case a suitability assessment is needed and the ECP status is not available under the current legal framework. Nevertheless, in those cases where investment advice is not provided, it is necessary to consider whether it would be desirable and feasible to change the way MiFID's client categorisation rules work for a set of highly complex products (such as asset backed securities and non-standard OTC derivatives). There are several possible approaches to changing the client categorisation rules. At this stage, CESR is consulting on the following ideas which are not mutually exclusive:

    - first, to say that ECP status is not available for transactions in highly complex products;

    - second, to define a "super ECP" status subject to stricter requirements (for example, large financial institutions instead of all regulated financial institutions) for highly complex products;

    - third, to require undertakings - either all or some, such as non financial undertakings - to request to be considered as ECPs and then requiring firms to consider whether they have the expertise, experience and knowledge to enter into transactions in highly complex products (when such transactions are contemplated) without relying on the investment firm to act on their behalf;

    - fourth, to require firms that know or have reason to know that an investor classified as an ECP is unlikely to be able to properly assess the risks of a particular instrument or transaction, to treat that investor as a professional client for the relevant transaction; this would require firms to do a minimum amount of 'know your customer' (KYC) (experience, knowledge and expertise) when they envisage highly complex transactions with ECPs.

Standards applying to business done with ECPs

36. When a client does business as an ECP this means that the protections in Article 19 do not apply. So an investment firm is not under a specific obligation to act "…honestly, fairly and professionally in accordance with the best interests of the client."

37. It makes sense that investment firms are not under an obligation to act in accordance with the best interests of the client when dealing with ECPs. The conduct of business obligations are turned off for such transactions because the ECPs are deemed to be able to look after

38. their own interests. However, the standards that do apply to business that investment firms conduct with ECPs are opaque.

39. It is clear that the conflicts of interest rules apply to such dealings (Article 24 of MiFID does not disapply these rules to dealings with eligible counterparties). Article 25 of MiFID also says that competent authorities have to monitor the activities of investment firms "…to ensure that they act honestly, fairly and professionally and in a manner which promotes the integrity of the market." This provision does not limit competent authorities' obligation to deal with retail and professional clients, but is not matched by a specific obligation on firms in relation to dealings with ECPs.

40. Given that ECPs are deemed to be able to look after their own interests, there should be no need to have a long list of standards applying to business done with ECPs. However, if clarification of the standards that do apply were felt to be necessary, then it could be made clear that in dealings with ECPs, investment firms have to:

    - act honestly, fairly and professionally; and

    - communicate with ECPs in a way that is fair, clear and not misleading.

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?

Annex 1 – Consultation questions:

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

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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?

Part 2: Public debt bodies

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

Part 3: Other client categorisation issues

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

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?

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