



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 FESCO⁽¹⁾, 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 FESCO, 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 FESCO 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.

⁽¹⁾ The Forum of European Securities Commissions (FESCO) assembles the following 17 Statutory Securities Commissions of the European Economic Area (EEA): Bundes-Wertpapieraufsicht (Austria); Commission bancaire et financière/Commissie voor het Bank- en Financiewezen/ Kommission für das Bank- und Finanzwesen (Belgium); Finanstilsynet (Denmark); Rahoitustarkastus (Finland); Commission des opérations de bourse (France); Bundesaufsichtsamt für den Wertpapierhandel (Germany); ΕΠΙΤΡΟΠΗ ΚΕΦΑΛΑΙΑΓΟΡΑΣ / Capital Market Commission (Greece); Financial Supervisory Authority (Iceland); Central Bank of Ireland; Commissione Nazionale per le Società e la Borsa (Italy); Commission de surveillance du secteur financier (Luxembourg); Stichting Toezicht Effectenverkeer (Netherlands); Kredittilsynet (Norway); Comissão do Mercado de Valores Mobiliários (Portugal); Comisión Nacional del Mercado de Valores (Spain); Finansinspektionen (Sweden); Financial Services Authority (United Kingdom). The European Commission attends FESCO meetings as an observer. The Chairman of the IOSCO European Regional Committee is also invited as an observer. FESCO is chaired by Georg Wittich, Chairman of the Bundesaufsichtsamt für den Wertpapierhandel (Germany). The Conseil des marchés financiers (France) participates in meetings of the expert group on investor protection.



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

- 8.** The members of FESCO recognise that the implementation of the definition of professional investor is inevitably linked to the contents of the relevant rules of conduct.

As the determination of comprehensive common standards on conduct of business rules warrants further study (currently underway), the scope of this paper is limited to the criteria that should be used to categorise investors as professionals.

FESCO is also committed to drafting standards at a later stage defining the conduct of business regime that will apply to inter-professional relationships. The members of FESCO will come back to this paper to consider whether the harmonised standards are suitable for the proposed categories of professional investors.

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 FESCO 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⁽²⁾,
- Investment firms⁽³⁾,
- Other authorised or regulated financial institutions ⁽⁴⁾
- Insurance companies.⁽⁵⁾
- Collective investment schemes and management companies of such schemes,
- Pension funds and management companies of such funds.

- b) National 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.

⁽²⁾ Within the meaning of the first indent of Article 1 of Directive 77/780: "Credit Institution" means an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account."

⁽³⁾ 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."

⁽⁴⁾ Within the meaning of article 1 (6) of Directive 89/646/EEC.

⁽⁵⁾ 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.

II. Investors who may be treated as professionals on request

II.1 Identification criteria

a) Large and institutional investors

12. The members of FESCO consider that the following investors will often not require the full protection of Conduct of Business Rules:
- a) financial institutions other than those mentioned in §10,
 - b) large companies and partnerships,
 - c) institutional investors other than those mentioned in §10 whose corporate purpose is to invest in financial instruments,
 - d) commodity dealers;
 - e) public sector bodies⁽⁶⁾,
 - f) issuers of listed financial instruments, i.e. entities whose securities (equity instruments or other) are traded on a regulated market⁽⁷⁾.

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 authorised, regulated financial entities listed in §10.

13. The large companies and partnerships referred to in §12. b) may be allowed to waive some of the protections afforded by the conduct of business rules subject to meeting two of the following size requirements⁽⁸⁾:
- balance sheet total : EUR 12.500.000,
 - net turnover : EUR 25.000.000,
 - average number of employees during the financial year : 250.

b) Other investors

14. The members of FESCO consider that investors other than those mentioned in § 10 and 12, including private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules.
15. 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.

16. In the course of the above assessment, as a minimum, two of the following criteria should be satisfied:

⁽⁶⁾ 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.

⁽⁷⁾ Within the meaning of article 1.13 of the ISD.

⁽⁸⁾ Criteria under article 27 of the Directive 78/660/EEC, on the Annual accounts of certain types of companies.

- 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^⑨ exceeds 0,5 million Euro;
- 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

17. The "*large and institutional investors*" defined above may waive some of the protections afforded by the conduct of business rules only after being informed in writing of the protections they will lose and stating in writing that they are aware of the consequences of losing such protections.
18. The "*other 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.
19. 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.

20. 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 action.

^⑨ Within the meaning of Section B of the Annex of the ISD.