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**A EUROPEAN REGIME OF INVESTOR PROTECTION
THE PROFESSIONAL AND THE COUNTERPARTY REGIMES**

JULY 2002

Foreword

This paper completes the work conducted by CESR on the harmonization of conduct of business rules under the existing Article 11 of the Investment Services Directive. It complements the document (Ref. CESR/01-014d) adopted in April 2002 on the so called “retail regime”, i.e. the regime applicable to investment services provided to non-professional customers.

This paper builds on the proposal for the “Categorisation of investors for the purpose of conduct of business rules” (see Annex). First an investment firm has to assess whether a customer is a professional according to the criteria of the last mentioned paper. After having done so, it knows whether it has to apply the standards and rules for non-professional customers (“retail regime”) or those for professional investors.

The paper contains: I) core conduct of business rules which should apply to investment services between investment firms and professionals and II) core standards for “counterparty relationships”. The Annex contains the revised “Categorisation of investors for the purpose of conduct of business rules”.

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

1. STANDARDS AND RULES OF GENERAL APPLICATION

1.1 GENERAL

- 1) An investment firm must at all times act honestly, fairly and professionally in accordance with the best interests of its customers ¹ 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) An investment firm must ensure that any persons or entities with which it is undertaking authorisable investment business are authorised to conduct that business by the relevant regulator.
- 4) An investment firm that outsources functions retains full responsibility for the outsourced activity and must ensure that the providers of such outsourcing are able to perform these functions reliably, professionally and in the best interests of its customers ².

1.2. CONFLICTS OF INTEREST AND INDUCEMENTS

- 5) 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 identified and then prevented or managed in such a way that the interests of customers are not adversely affected.

¹ “Customer” is intended to be a “professional customer” according to the categorisation paper.

² This standard is not intended to interfere with relevant provisions on civil liability, applicable at national level.

For these purposes the investment firm must establish an internal independence policy, including Chinese walls as appropriate. Where conflicts of interest cannot be reasonably avoided or managed with the internal independence policy, the conflict of interest must be disclosed to the customer.

- 6) An investment firm, its members of the body, directors, partners, employees and tied-agents may offer or receive inducements only if they can reasonably assist the firm in the provision of services to its customers. Where inducements are received disclosure of such inducements must be made to the customer on his request.

1.3 COMPLIANCE AND CODE OF CONDUCT

- 7) An investment firm must take all reasonable measures to ensure that the firm and its members of the board, directors, partners, employees and tied-agents at all time act in accordance with the best interests of its customers and the integrity of the market by establishing and implementing adequate compliance policies and procedures, including an independent compliance function and an internal code of conduct.
- 8) An investment firm must be able to demonstrate that it has not acted in breach of the conduct of business rules and the internal code of conduct and that its organization, policies and procedures facilitate such compliance.
- 9) The persons responsible for the compliance function must have the necessary expertise, resources, authority and must have full access to all relevant information enabling them to perform their duties. They must perform their monitoring duties independently of all persons and activities subject to their monitoring.
- 10) A summary of 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.
- 11) An investment firm must ensure that the competent authority is informed, without undue delay, of serious breaches of the conduct of business rules. 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.
- 12) The compliance function must:
 - regularly verify the adequacy of policies and procedures to ensure compliance with the regulations on investment services;
 - provide advisory assistance and support to the various business areas of the investment firm on problems concerning compliance with the regulations on investment services.
- 13) An investment firm must keep records relevant for the purpose of demonstrating compliance with the conduct of business rules, for a period of five years in order to enable the competent authority to verify compliance with these rules. Tape recording of orders must be kept for a period of one year.
- 14) 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 and must regularly verify whether complaints are adequately processed.
- 15) An investment firm must establish a code of conduct for members of the board, directors, partners, employees and tied-agents. The code of conduct must contain:
 - a) The rules and procedure to meet 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.

2. INFORMATION TO BE PROVIDED TO CUSTOMERS³

- 16) 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.
- 17) If an investment firm provides information in a marketing communications it must be fair, clear and not misleading.
- 18) An investment firm must ensure that a customer is provided promptly with the essential information concerning the execution of his order.
- 19) 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.
- 20) An investment firm that operates customer accounts, which include uncovered open positions, must provide regular statements of such positions.

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

- 21) 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 adequate documentation of 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 a) to determine whether the investment services envisaged are appropriate for the customer and b) to meet any duties owing to the customer in respect of the services to be provided.
- 22) When an investment firm provides investment advice 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 investment advice is suitable for him.

4. CUSTOMER AGREEMENTS

- 23) Prior to providing any investment service, an investment firm must enter into a signed 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

³ 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.

- 24) An investment firm must record and process orders in accordance with the customer's instructions and in such a way as to facilitate best execution.
- 25) An investment firm must ensure that the firm and its members of the board, directors, partners, employees and tied-agents do not use the information they possess on customers orders to the disadvantage of customers' interest.
- 26) An investment firm must record orders immediately, documenting and verifying all relevant items of proper execution.
- 27) An investment firm must keep a record of telephone orders on magnetic tape or an equivalent medium. Investment firms must duly inform the customer that the conversation will be recorded.

5.2) EXECUTION OF ORDERS

- 28) An investment firm 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 trading 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 be able to demonstrate to the customer that this was done in accordance with his best interest.
- 29) An investment firm acting as principal in relation to a customer order must inform the customer accordingly beforehand and must be in a position to justify the price at which the transaction is executed, with reference to the prices and volumes in the relevant market(s), where appropriate, or the presumed value determined on the basis of objective elements, e.g. mark-to-market.
- 30) An investment firm must ensure that orders are executed in accordance with the instructions from the customer.
- 31) An investment firm takes reasonable steps to refrain from executing orders for its own account or the account of its members of the board, directors, partners, employees and tied-agents before those of customers in identical or better conditions than the latter ("front running").

5.3) POST- EXECUTION OF ORDERS

- 32) An investment firm must ensure the proper and speedy recording, allocation and distribution of executed transactions.
- 33) 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 an aggregated order is 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 standards and rules, additional provisions apply to the service of individual portfolio management.

34) 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.

35) 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.

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

37) 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.

II. CORE STANDARDS FOR « COUNTERPARTY RELATIONSHIPS »

The “counterparty relationship”

A « counterparty relationship » is typical of trading between investment firms and banks within themselves or with other entities which are not holding themselves out as providers of investment services but are market participants directly active in the financial market for proprietary trading. It is characterised by the absence of a “client relationship” (i.e. without any provision of service). In particular, it covers the following situations:

- transactions executed in regulated markets or other trading venues (which do not give rise to any provision of investment service to the customer) between any member admitted to trade in these markets;
- transactions executed directly (over-the-counter) between investment firms or credit institutions, authorised to provide the service of dealing, and dealing either as principal or as agent;
- transactions executed directly (over-the-counter) between investment firms or credit institutions and other authorised or regulated financial intermediaries, including non-ISD firms, such as commodity dealers, insurance companies, but not including collective investment schemes and management companies of such schemes, pension funds and management companies of such funds.

CESR Members are free to allow companies to be treated as “counterparties” and to define the appropriate quantitative thresholds. In case of cross-border business, if the company is located in a jurisdiction where the “counterparty regime” is not applicable to companies, the professional regime will apply to that relationship.

Transactions entered into by these entities and effected through the offices of an authorised intermediary would be, by default, subject to the « professional regime ». Only those transactions undertaken by these entities for which they are direct “counterparties” and for which a specific choice to enter into a “counterparty relationship” has been made, are liable to operate subject to such a 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 ». This confirmation may be given in master agreements, where applicable to a series of transactions of the same nature.

The “counterparty regime”

No service being provided to a customer, there is no need for applying conduct of business rules for investor protection purposes. However, all requirements imposed for market integrity will apply ⁴, including the following standards:

- ***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.***

⁴ The “counterparty regime” is without prejudice to any other initiative undertaken in the field of market abuse prevention. In particular, CESR has published a document for measures to prevent market abuses. Furthermore, a political agreement was achieved in the European Council on the proposal for an European directive on market abuse.

- *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 not acted in breach of standards of market integrity and that its organisation, policies and procedures facilitate such compliance.*
- *The firm must keep records of all transactions executed for a period of five years.*
- *The firm must keep record of telephone conversations concerning the transactions executed on a counterparty relationship.*
- *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.*



ANNEX

A EUROPEAN REGIME OF INVESTOR PROTECTION
CATEGORISATION OF INVESTORS FOR THE PURPOSE OF CONDUCT OF
BUSINESS RULES

Introduction

1. Article 11 of the Investment Services Directive (ISD) states that rules implementing its standards 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 standards, 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 standards 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.

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 ⁽⁵⁾
- Investment firms ⁽⁶⁾
- Other authorised or regulated financial institutions ⁽⁷⁾
- Insurance companies ⁽⁸⁾
- Collective investment schemes and management companies of such schemes
- Pension funds and management companies of such funds
- Commodity dealers.

- b) Large companies ⁽⁹⁾ and other institutional investors:

- large companies and partnerships meeting two of the following size requirements on a company basis:
 - balance sheet total : EUR 20.000.000,
 - net turnover : EUR 40.000.000,
 - own funds: EUR 2.000.000.
- Other institutional investors whose corporate purpose is to invest in financial instruments.

⁽⁵⁾ 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.*"

⁽⁶⁾ 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.*"

⁽⁷⁾ Within the meaning of article 1(5) of Directive 2000/12/EC.

⁽⁸⁾ 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.

⁽⁹⁾ Whilst CESR acknowledges that issuers of listed financial instruments, i.e. entities whose securities (equity instruments or other) are traded on a regulated market (within the meaning of article 1.13 of the ISD), should be treated as professional investors, Members are free to implement the categorisation of these issuers in line with the thresholds applicable to large companies and partnerships.

- 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.

14. 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. Where the customer of an investment firm is a company or a partnership referred to in §10, the investment firm must inform it prior to any provision of services that, on the basis of the information available to the firm, the customer is deemed to be professional investor, and will be treated as such unless the firm and the customer agree otherwise. The firm must also inform the customer that he can request a variation of the terms of the agreement in order to secure a higher degree of protection.
12. 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.
13. 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

14. The members of CESR consider that investors other than those mentioned in § 10, including public sector bodies ⁽¹⁰⁾ 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.

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:
- 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;

⁽¹⁰⁾ 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.

- The size of the investor's financial instrument portfolio, defined as including cash deposits and financial instruments ⁽¹¹⁾ 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 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.

18. 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.

19. 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.

⁽¹¹⁾ Within the meaning of Section B of the Annex of the ISD.