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

Executive Summary

The Association for Financial Markets in Europe (“AFME”), the International Swaps and Derivatives Association, Inc (“ISDA”), the International Capital Market Association Ltd (“ICMA”) and the British Bankers’ Association (“BBA”) appreciate the opportunity to respond to the CESR’s consultation paper on client categorisation and hope that our comments will be helpful in developing proportionate recommendations to the Commission on the questions it has raised.

Despite public commentary to the contrary, in general, we believe that the current tiered approach to customer categorisation provides appropriate levels of investor protection to the three categories. Our experience has shown that transactions executed since the implementation of the regime have not resulted in significant numbers of client complaints and that the regime provides a proportionate and graduated system of investor protection that is relatively recent, has been implemented at significant cost and is maturing well. The ability of clients to opt for greater regulatory protection at any time is an important safety feature already built into the process and should not be overlooked in suggesting any changes to the regime.

We agree that professional clients per se (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. However these differences should not in and of themselves suggest differences in their capabilities to properly assess the risks of the financial markets in which they participate or in asking for

more protection where they have doubts. We acknowledge that, as with the setting of any threshold, there is a risk that those that should be included have been left out and that some of those included should not have been. Nevertheless, we believe that the current regime strikes the right balance on this front. If the current threshold was perceived by clients as being set too low we would have expected to see significant numbers of clients request greater levels of regulatory protection. Although there is little published data available on this topic, our members estimate this at less than 1% of these categories

We support the proposed changes in standards for eligible counterparties, harmonisation and clarity on the treatment of local authorities and some minor definitional improvements to regulated entities.

We do not believe any increase in knowledge tests or further distinctions between the regulated entities described in Annex II.I are warranted.

We would of course be happy to discuss any aspect of this response with you.

Our responses to the questions in the consultation paper are:-

- 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.”?**

We agree that the sentence “Entities which are required to be authorised or regulated to operate in the financial markets” sets the scope of all the entities that follow in (a) to (h).

Section (i) we believe requires further clarity on exactly how it currently operates and is linked to section I (4) of the same Annex.

Under (i), the entities according to CESR’s description in the Consultation Paper would also include entities which fall under Article 2 of MiFID (i.e., regulated under a different regulatory framework or unregulated because they are subject to one of the MiFID exemptions). The Consultation Paper on page 6 makes reference to the fact that this category would include entities “mainly focused in investing in financial instruments”. Such entities would therefore include, amongst others, entities that fall under the exemption of Article 2 (d) MiFID (persons who do not provide any investment services or activities other than dealing on own account...) and Article 2 (f) MiFID (persons which provide investment services which only involve both administration of employee-participation schemes and the provision of investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings), even though such entities would not be authorized or regulated. We would therefore expect entities offering investment services to their affiliates to qualify as professional clients under this section.

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.**

Inasmuch as the entities included in points (c), (h) and (i), as with the others identified in Annex II.I, are all actively engaged in the capital markets and are either authorised or regulated in those activities, they will be among the most *au fait* with the current MiFID rules, including those which permit such entities to request treatment as “non professional”. It is difficult to understand therefore the need, or perceived need, to narrow the range of entities included in these points.

These points however could almost certainly be improved through definitional clarity to remove any doubt of the types of entities included within the scope of the current terms. To that end, we would support 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 more clarity on the criteria defining “other institutional investors” in point (i).

See also the point on Q&A website in response to question 4.

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?**

See our answer to question 2.

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?**

See our answer to question 2. It may also be helpful to set out some typical examples and their appropriate treatment on the Q&A section of the Commission’s website. Whilst there are currently very few issues that have been posted on this topic, possibly reflecting the fact that the current regime is well understood by market participants, we believe the website is an appropriate tool for clarifying such language and encouraging a consistent understanding of the coverage of Annex II.I in the market.

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?**

We agree that amendments which define the terms “local authorities”, “municipalities”, “public bodies that manage public debt” and “public sector bodies” should be introduced and then used consistently throughout the directive. Such changes will provide much needed clarity as to how firms dealing with such entities must act in those dealings.

We support the view that local authorities and municipalities should be specifically excluded from the definitions of entities in Annex II.1 (3) and from the size criteria of Annex II. 1 (2) and therefore could only be treated as professional if they meet the criteria and follow the process set out in Annex II part II.

We believe a further enhancement to clarity and consistency of treatment of “local authorities” would be achieved by the Commission publishing summaries of the abilities of “local authorities” to engage in financial market activity under national laws and rules governing their constitution.

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?

We believe that those entities currently included in Annex II.I are all highly likely to be actively engaged in the capital markets and are by their very nature among the most *au fait* with the current MiFID rules, including those which permit such entities to request treatment as “non professional”. We believe that 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 been required. The cost and effort to carry out and maintain records of such assessments would therefore far outweigh the possible benefits of doing so. Further, in those 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, our experience suggests it will almost always involve professional advisers, including law firms, which will be able to advise on the existence of the “opt down” provisions. The cost of administering a set of knowledge and experience assessments for the very small subset of *per se* professionals that could potentially be impacted seems a disproportionate and an unnecessary burden given our experience with such entities.

In summary, we believe that all professional clients under Annex II are fully capable, able and, most importantly, actually do, ask for a higher level of protection where they feel they are unable to properly assess or manage the risks involved.

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?

We do not believe that knowledge and experience tests need to be expanded to cover any of the *per se* professional categories. As implied in the previous answer, in our experience, the entities which currently qualify as large undertakings are frequently engaged in the capital markets and, in any case, engage sophisticated counsel when engaging in investment business. The

additional burden implied by applying knowledge and experience tests would be out of proportion and, in fact, yield no real benefit to such entities, which already avail themselves, when necessary, of the “opt down” provisions in Annex II.

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

We do not believe that client categorisation rules need to be changed in relation to product types and would like to understand further the perceived failing of the current regime and the evidence that supports the issues that have been raised. We are of the initial opinion that any solution that may be necessary is available from consistent and active enforcement of existing requirements at institutions and by competent authorities, rather than by changes to MiFID client classification requirements, which were not primarily designed to prevent or protect against misrepresentation and fraud.

As you are aware, “OTC derivatives” covers an enormous range of products which range in complexity from the very simple to the highly complex. To categorize all as “complex” would not be correct. Further, it is not straightforward to construct a definition and underlying criteria for OTC derivatives and complex products that would be consistently successful in distinguishing which instruments are simple from those which tend to be more complex. In addition, given the pace of product innovation, any listing of complex transactions would quickly become outdated.

It seems unlikely, particularly in light of the current environment, that a party which is professional within the definition of Annex II of MiFID and which believed that it did not have adequate experience, knowledge and expertise to make its own investment decisions relating to a derivative transaction or a complex security investment or to properly assess the risk that it would incur in taking such investment decisions would not either specifically request additional information or hire expert assistance to assist it in its decision making process. Further, inasmuch as a professional client can always request that it be opted down to be treated as a non professional client, the protection that would result from changing the categorization of a the party as a result of the perceived complexity of a transaction can already be achieved by the party itself without changing the existing framework.

A false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments. In fact in OTC derivative markets product complexity is often the result of products being structured to create more tailored and, quite possibly, less risky investment outcomes. For example, contrast the case where a client pays 3 month Euribor with one where the client pays 3 month Euribor capped at 5% and floored at 1%. The first case involves a much simpler product and payment structure but has a higher exposure to outright interest rates than the second example which effectively limits exposure to parameters chosen by the client.

Further, if a client has a complex liability profile, a complex hedge will be a necessary requirement to match risk profiles. Any vanilla or less structured solution could leave the client with exposure to significant net risk which would require a high level of risk management expertise to monitor and manage.

The consultation refers to instances where clients have suffered losses on complex derivatives but we feel that it is important to put this issue into context. Many complex products are structured precisely to ensure that they match a client's liabilities over the term of those liabilities. As a result, if a client chooses to exit the hedge early or is forced to evaluate the mark to market of the hedge trade in isolation to the mark to market of its liabilities, it may appear that the client has suffered a loss. However by trade construction a hedge trade is designed to offset losses/gains in the underlying liability and hence it does not make sense to evaluate the complex product's effectiveness or risk exposure on a stand alone basis.

In summary, the suitability of a particular product for a particular investor is a function of the investor's knowledge and experience, financial situation and investment objectives. The complexity or otherwise of a product is just one factor in the making this determination – what matters is whether the investor understands what the risks are and what the returns are likely to be.

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?

See answer to question 8

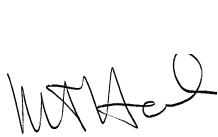
10. Do you believe it is necessary to clarify the standards that apply when an investment firm undertakes a transaction with an ECP?

We believe that the standards that apply when dealing with eligible counterparties are clearly set out in the directive and require no clarification.

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

An important element of the transactional relationship between eligible counterparties is that each can rely on the other to look after their own interests. The majority of regulatory obligations that apply to "clients" are therefore rightly disapplied in these circumstances. We believe this should continue to be the principle on which transactions between eligible counterparties are carried out and that the opt down feature should be utilised wherever counterparties wish to rely on regulatory protections otherwise owed to "clients", such as best execution for example.

Notwithstanding the fact that we believe that the standards do not require clarification, we would support changing the existing standards such that they included obligations for eligible counterparties to act honestly, fairly and professionally; and to communicate in a way that is fair, clear and not misleading as we see these as pre requisite for any lasting commercial relationship or properly functioning market.



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AFME

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. See: www.afme.eu.

ISDA

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risk inherent in their core economic activities. See: www.isda.org.

ICMA

The International Capital Market Association is a unique self regulatory organisation and an influential voice for the global capital market. It represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges, central banks, law firms and other professional advisers.

ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years. See: www.icmagroup.org.

BBA

The British Bankers' Association is the leading association for the UK banking and financial services sector, speaking for 220 banking members from 60 countries on a full range of UK and international banking issues. All the major banking institutions in the UK are members of the Association as are the large international EU banks, the US banks operating in the UK, as well as financial entities from around the world. The integrated nature of banking means that our members engage in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment bank and wealth management as well as conventional forms of banking. See: www.bba.org.uk.