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

The ea Consulting Group (eacg) welcomes this opportunity to respond to the above consultation paper (CP) which covers aspects of the client categorisation regime applying under the MiFID conduct of business rules.

By way of background, eacg was founded in 1998. It was originally set up to address the regulatory issues associated with euro integration. Since its inception it has greatly expanded its areas of expertise and today eacg's extensive consultancy operation includes the provision of project and programme management services primarily for the European financial services industry with many clients operating in the capital markets sector. As a result the business has grown substantially with eacg recognized by the Sunday Times Virgin Fast Track 100, in both 2008 and 2009, as one of the fastest growing unlisted companies in the UK.

With regard to this CP, eacg has been associated with MiFID throughout its history. eacg personnel were responsible for the successful implementation of MiFID for a number of major international banks based in the UK and in continental Europe. All adopted the new MiFID client categories in the period 2006-2007 although, for the sake of simplicity, countless recommendations were made to take advantage of Article 28(3). Since this time ever more complex derivatives have entered the marketplace and, in general, client understanding of product structure and inherent risks has fallen at all levels. Inevitably, attention is now being given to the review of MiFID and the series of CPs issued on the subject published by CESR.

The responses to the 11 questions raised in the CP 10-831 are to be found in the appendix. It is, however, appropriate at this stage to highlight our key concerns and to emphasise the need for a proportionate regime that is easily understood and appropriately policed by national supervisors. It is firmly believed by eacg that an overarching principle of 'treat your customers fairly' should apply for all directives and, in this case, irrespective of professional or ECP status.

Client categorization and the various levels of protection afforded is, of course, an area of fundamental importance to both clients and the investment industry. The EC has rightly been concerned by market experience gained in the 2008 global banking crisis when it appears many local authorities had often been attracted by the prospect of a higher return and, like their retail cousins, conducted minimal due diligence. It is a great pity that such authorities did not adopt the standard maxim that if a rate looks too good to be true it probably is. Matters have again been highlighted by a fine of \$550M recently levied by SEC on Goldman Sachs involving a mortgage derivative purchased or insured by many large European institutions (eg ABN AMRO). It transpires that even ECPs were unaware of the true risks associated with an investment involving sub-prime debt and the integral part played in the derivative's gestation by a hedge-fund. As a side issue, this example also raises the thorny subject of penalties reflecting the crime (and size of the offender) and their applicability and enforcement globally to a common scale. Clearly, client categorisation reform is necessary as client detriment has been identified but it must be proportionate and workable.

Going forward new structured products of ever increasing complexity are inevitable as clients will always strive to maximize returns and/or minimize risk exposure. Revised MiFID rules must not stifle this innovation. However, it is sensible in the protection arena that the limitations of ECP status are always highlighted. If doubts exist over the validity of a particular type of investment, commonsense should dictate that treatment as a professional client is more appropriate and, preferably, mandatory. Care must be taken that we do not create a vast industry identifying the investment capabilities of firms by organization, section or individual regarding their understanding of ranges of products or specific investments. We must accept that such information is dynamic and will change with personnel experience and/or staff turnover. For the identification of professional/ECP clients we continue to need broad categories that can be subject to simple rules that are easily understood by all parties.

It has been noted that following feedback from stakeholders to this CP, CESR will not be drafting specific rule changes covering client categorisation for MiFID. However, eacg look forward to seeing '*a suggested policy approach*' for consideration by the EC in due course.

If further clarification is required on any point please do contact me directly.

Yours sincerely,

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APPENDIX

CESR/ 10-831 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)]

- 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."?**

YES- eacg is in total agreement with CESR that the opening statement in Annex 11.1(1) is the primary ruling on "Categories of client who are considered to be professionals". All the additional comment in the paragraph simply clarifies the nature of the authorization or regulation for the list of entities that follows.

Annex 11.1(1) reads:

"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 Directive, entities authorised or regulated by a Member State without reference to a Directive, and entities authorised or regulated by a non-Member State:"

- 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.**

From recent experience gained during the global banking crisis of 2008 it is apparent that some entities identified by the standard MiFID criteria to be "per se" professional clients have in the final analysis lacked the financial knowledge and expertise anticipated for organizations operating in the investment sector. This situation is likely to be exacerbated by the development of products of ever increasing complexity in the future.

eacg believes that it is necessary to provide the clarification discussed in outline in the CP concerning Annex 11.1(1) for:

- (c) Other authorised or regulated financial institutions
- (h) Locals and
- (i) Other institutional investors.

- 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?**

YES- Further to our answer to Q2, eacg supports a revised scope for the entities encompassed by items (c), (h) and (i) in Annex 11.1(1). It must be in the interest of all parties that the additional

criteria can establish definitively that the entities involved should have the appropriate client classification reflecting their experience for the types of investment under consideration.

The additional qualification criteria discussed in the CP are entirely appropriate and will help define 'scope'. In summary, firstly for (c) this should involve reference to the CRD definition of a 'financial institution'. Ideally, all EU directives should adopt common definitions and avoid regulation being created in silos. Secondly for (h), where no further information is currently given regarding the nature of 'local', wording should be added as suggested directing the reader to the content of Article 2(1)(l) of MiFID for guidance. Article 2(1)(l) reads:

(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;

Finally, for (i), it is essential that all parties know that the 'other institutional investors' must be engaged in investing in financial instruments as a primary activity. This last change is very important as any entity conducting investment business as a secondary or occasional activity should clearly not have per se professional status.

Overall, such clarity will ensure uniformity of treatment across all Member States.

In terms of additional criteria, as identified in the CP, further enquiry can be made over whether 'the entity was regulated or authorised in a jurisdiction with an equivalent regulatory regime to the EU', and 'whether the entity was conducting business on behalf of underlying clients or not'. However, we do not support the suggestion that 'size of entity' criteria should also be considered for 'other authorized or regulated financial institutions' and 'other institutional investors'.

Annex 11 includes a number of thresholds and it is believed that a further set of numeric parameters arbitrarily set will simply complicate the matter. Annex 11.1(2) already identifies under 'Categories of client who are considered to be professionals' any *large undertaking meeting two of the following size requirements on a company basis:*

- *balance sheet total: €20 000 000*
- *net turnover: €40 000 000*
- *own funds: € 2 000 000*

Annex 11.11 (1) states that a client may be treated as professional on request if two of the following criteria are satisfied:

- *the client 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 client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,*
- *the client 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.*

Presumably, much research was undertaken prior to publication of the original directive Level 1 text to validate the benchmarks imposed. As such, no attempt has been made here to update these figures or to suggest a new range of 'size of entity' figures for points (c), (h) and (i).

Adopting a different set of figures is unnecessary (and potentially confusing) as they should prove superfluous in light of the improved text concerning 'scope' now recommended.

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?

The clarification required is we believe minimal and should be succinct. eacg suggests that the list provided in Annex 11.1(1) should simply be amended to read:

- (a) Credit institutions**
- (b) Investment firms**
- (c) Other authorised or regulated financial institutions as defined under Article 4(5) of CRD 2006/48/EC**
- (d) Insurance companies**
- (e) Collective investment schemes and management companies of such schemes**
- (f) Pension funds and management companies of such funds**
- (g) Commodity and commodity derivatives dealers**
- (h) Local entities complying with MiFID Article 2(1)(l).**
- (i) Other institutional investors investing in financial instruments as a primary activity**

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?

YES – Clarification is required to exclude local authorities so that Annex 11.1(3) can more accurately reflect the content and spirit of Article 24(2) of the Level 1 text. The latter is more extensive and must be considered the primary ruling on this matter.

Annex 11.1 (3) covering "Categories of client who are considered to be professionals" states: *'National and regional governments, public bodies that manage public debt, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.'* Whilst Article 24 (2) concerning ECPs reads: *'Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Community legislation or the national law of a Member State, undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations. Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 19, 21 and 22.'*

Following the additional guidance provided on the MiFID Q & A website in ID249, eacg welcomes a clear statement that public bodies that manage public debt do not include local authorities will end any debate on the subject and ensure uniformity of treatment across Member States.

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?

eacg believes that investment firms should satisfy themselves that entities identified per se as 'professional' by the standard MiFID client categorization parameters do indeed have the appropriate knowledge and experience. The investment firm is required to provide details to their client of their classification (and the implications for protection and option to apply for greater protection generally or for a particular trade) and it should be established at the outset the nature of business transacted and trading experience. Such information should suffice for a continuing relationship but if a client commences trading in a new category of complex products a warning should be provided informing the client of their right to seek greater regulatory protection. As recognized in the CP, this requirement is of particular relevance with unregulated undertakings that only qualify as professionals under Annex 11.1(2) by virtue of their size.

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?

See response to Q6. eacg believes that a knowledge and experience test should be applied for all clients at the commencement of any trading relationship.

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

YES – but it is very important to remember that derivatives will continually evolve with ever increasing complexity and any regulation that is product specific can become quickly outdated. Anecdotal evidence indicates that even major institutional investors can have little understanding of the operation of the more complex securities (eg ABS, ARS). This situation is unlikely to improve in the future as increasing complexity is the order of the day to meet new investment or risk goals.

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?**

In reviewing recent market experience, it is immediately apparent that consideration should be given to ensure that the 'light touch' ECP regime does not apply to the more highly complex derivatives. This will require investment firms to conduct a "KYC" appraisal prior to any investment decision concerning

such products. Although some per se ECPs (eg credit institutions, insurance companies, pension funds, national governments) may regret such a move and believe it to be overly bureaucratic, we have witnessed client detriment as a direct result of the existing broker/client asymmetry regarding the more complex derivatives. On examining the various options put forward by CESR in the CP, eacg believes that this solution to potential mis-selling is likely to be the most effective by virtue of its simplicity. It has a key advantage in that it should be readily understood by all parties providing, of course, that there is a common interpretation of the definition of a 'highly complex' derivative.

The recent Goldman Sachs case highlights that ECP status does not guarantee understanding of the more complex derivatives and the inherent risks of such investments. Of the major banks involved (RBS, ABN AMRO, IKB) it is suggested that all might qualify for "super ECP" status? In the spirit of MiFID, commonsense should dictate that, irrespective of scale, the investor and broker have a relationship based on suitability or appropriateness not a guiding requirement for caveat emptor to apply and the hope that the investor understood the risk(s). In the Goldman Sachs case, major institutional investors were clearly unaware that sub-prime mortgages in the ABACUS 2007-AC1 CDO had been selected through the hedge fund firm Paulson & Co which, of course, took a short position against the bonds. The new client categorisation rules must place responsibility on the broker to 'treat the customer fairly' at all times irrespective of their trading trading status.

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

See response to Q9. The conduct of business obligations in the MiFID Level 1 text do not, of course, apply to ECPs as they have always been deemed to be capable of looking after their own affairs. As Article 19 does not apply, an investment firm dealing with an ECP is under no obligation to act '*honestly, fairly and professionally in accordance with the best interests of the client.*' The few standards that do apply for ECPs are far from transparent (eg conflict of interest).

eacg believes that the number of standards that apply to ECPs should continue to be minimal for this category of client but all should be clearly stated in the governing MiFID text. Whilst ECPs should for the vast majority of their activities be able to look after their own interests there is an exception concerning transactions involving the more highly complex derivatives. The standards applying should be re-written to reflect this exception.

As previously stated, eacg firmly believes that for investment firms an overarching principle of 'treating your customers fairly' should apply across all client categories including ECPs.

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

See response to Q10. If more elaborate instructions are required (in addition to our recommendation that an overarching principle of '*treating your customers fairly*' should apply) we are fully supportive of the suggestion in the CP that where investment firms deal with ECPs they must '*act honestly, fairly and professionally*'. If communicating with ECPs they must do so in

a way that is '*fair, clear and not misleading*'. Indeed, any ECP would expect these standards from their broker irrespective of any express statement on the subject.