



August 9th, 2010

CESR'S CONSULTATION MIFID REVIEW – CLIENT CATEGORISATION

FRENCH BANKING FEDERATION'S RESPONSE

GENERAL REMARKS

1. The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 500 commercial, cooperative and mutual banks. FBF member banks have more than 25,500 permanent branches in France. They employ 500,000 people in France and around the world, and service 48 million customers.

As universal banks, French credit institutions were directly and highly impacted by the enforcement of the MiFID on their main business lines and especially as regards the rules guiding the contractual relationship between the credit institutions and their clients. As the client categorisation was one of the main structural pillars of the MIFID in this perspective, the FBF welcomes the opportunity to share its views about the existing framework.

2. The FBF regrets the very short timeframe on the current consultation, especially as regards the potential operational impact of the possible changes in the regulation. Considering the numbers of areas of regulation at both national and EU level and consequently the number of consultation paper, the FBF considers inappropriate such a short timeframe (only 4 weeks in summer).

3. From a general point of view, the FBF would like to express three general statements.

- **About the categorisation of professional investors, the FBF does not see any need to change the current regulation, with three categories (retail, professionals and eligible counterparties- ECPs) which is appropriate to address the issues arisen from the relationship between investment banks and their clients.**

Especially, professional investors already have a right to be classified, market by market, product by product or in general, as retail investors. In many cases, they

concretely use this faculty given by article 28 of the level 2 directive. This is a very important safety feature embedded in the Directive that should not be forgotten in designing changes to the categorization rules. This means that a categorisation is never definitive and a client, under MiFID, can always benefit from a higher level of protection if he chooses so. And when it appears due the client has not enough knowledge or expertise and then prefers to be treated as a retail client, the investment bank does not propose investment products designed for professional investors. From FBF's perspective, it would not be relevant to apply new regulatory constraints to investment services providers for practices observed, as CESR recognizes, only in the USA (the given example of securitization is quite eloquent).

The creation of new categories would lead to a less readable framework, especially regards non EU investors and would at the end of the day be detrimental to the practicality of the text.

The FBF strongly believes that, to safeguard the essence of professional clients, it is better to have a list of *per se* professionals that is clear and undisputable, rather than create sub-categories within it that would require the implementation of multi-dimensional procedures, which present a high risk of confusion both from the point of view of an investment firm's staff and clients and are likely to result in unintentional regulatory breaches and clients' complaints.

The experience of the relationship between investment services providers and their institutional clients has proved, not only since the implementation of the MiFID, that these clients are not willing to excessively formalize this relationship and that in this perspective it would be detrimental to add new written procedures to the MiFID which is already seen by the institutional clients as a heavy process.

- **About public debt bodies, the FBF agrees that the current legislation could be improve. The FBF however estimates that the first step is to clearly define what is a public authority and what is public debt management, since there are high differences across Europe in these areas** (for example, in France, there are three floors of public local government: Regions, departments and municipalities, and local administrations dedicated to the public management of health system).
- **Concerning the distinction between complex and non-complex products, the FBF points out the fact that the main interest for clients is not to exactly know how the product works but to clearly assess the underlying risk.**

The FBF has always considered that the key distinction is this perspective is not between complex and non complex products but between risky and non-risky products. This said, as it seems unavoidable (the distinction between complex and non complex products is also used at IOSCO level) to have to made such a distinction, the FBF considers as a necessity to add, in order to make this distinction more efficient and readable, a secondary distinction based on the risk. It means than a complex products would have an impact on the treatment of the client only if the complexity generates a specific risk, while those whose complexity does not generates any specific risk would not.

The FBF highlights that cash equities are not complex but are risky by nature (the investor could lose 100% of the invested capital), while some structured equity funds,

complex in the functioning, are characterised by a partial or a full guarantee in capital which make them far less risky than cash equities.

The FBF also rejects the idea of distinction between complex and highly complex products which would not be relevant as regards the high structural differences between asset classes and would lead to illogical classification.

SPECIFIC REMARKS

II. – 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)]

Q 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, the FBF shares CESR's analysis that points (a) to (i) are examples of entities which are required to be authorised or regulated to operate in the financial markets.

Q 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.

No, the FBF does not consider there is a case for narrowing the range of entities covered by points c, h and I for the following reasons.

c. Other authorised or regulated financial institutions

The scope of Annex II.I.(1) of the Directive contains entities authorised or regulated by a Member State and or by a non Member State, of which credit institutions and investment firms are considered in points (a) and (b) and asset managers in point (e). It is not clear therefore which financial institutions this category is aiming at. One possibility could be that it targets regulated entities whose status is specific to a Member States (like “*conseillers en investissements financiers*” in France). If it is so, the FBF believes that, to clarify this point, each Member State should communicate to the European commission (or ESMA) which entities it includes in this category.

h. Locals

The definition proposed by CESR does correspond to the transposition that France has made of this point. However one can wonder why these entities are called “locals” as there is no geographical concept attached to this definition. Some further clarification in this respect is needed (see our response to question 5)

i. Other institutional investors

The FBF believes that a clear definition of “other institutional investors” could be usefully given, based on the following criteria: entities whose main activities, by regulatory obligation or by the statutes, is to invest in financial instruments.

Q 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?

These three categories are not used extensively by firms to classify their professional clients. The issue here is more theoretical (in terms of clarifying their definition as proposed by CESR) and it does not seem that complaints/issues occurred in practice with these three points as far as mis-classification is concerned. The FBF therefore does not think that there is a case for narrowing the range of these three points.

Having said that, if the criterion of the equivalence of a jurisdiction is kept then it is critical that the list of such jurisdictions be provided. As for the criterion regarding whether the entity conducts business on behalf of underlying clients or not, it is not adequate, as this has no impact on whether an entity has proper knowledge and expertise (the protection – and knowledge - of the underlying clients being a separate issue).

As to the third proposed criterion, the size of the entity, this is in FBF's view not acceptable as these entities covered by points (c) and (i) are regulated or authorized and have therefore been judged by regulators "true" professionals irrespective of their size, *i.e.* they should at least have enough knowledge and expertise to know when they do not know something and request more information or an opt-out to a safer category. If not, one can have doubt as to the appropriateness of the authorization they have been given or as to the quality of the supervision applied to them.

Q 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 answer to question 2.

Part 2: Public debt bodies

Q 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?

As stated in the general remarks, it would be really useful to have a clear definition of what is a local authority (local government, local administration...). Otherwise, there will always be an ambiguity in this classification as regards the high differences between EU countries in this area.

With such a definition, it would be easier to identify those which manage public debt.

Under these reservations, the FBF agrees with CESR's proposals and considers that only local authorities who concretely manage public debt should be treated as professional *per se*.

Part 3: Other client categorisation issues

Q 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?

The FBF does not believe it is appropriate because such proposal denies the principle underlying MiFID client categorisation rules. Testing professional clients would render meaningless the list of *per se* professional clients.

As stated before, there should be no doubt that entities listed as *per se* professionals are truly professionals, which anyway is not irreversible as any such client can change category in general or for a particular transaction if he or she wishes so.

In addition, testing professional clients for knowledge and expertise raises practical issues: if one could argue that an entity's expertise could be tested looking at its past transactions, what about its knowledge? Should the test be performed on individual(s), and if so on whom? If so, would the test be valid for the entity or would it be attached to the individual himself (with the resulting issues linked to staff turnover, etc.)? Such a testing process would be very onerous for firms for little benefit considering that as for now, it does not seem that there have been major issues of client's misclassification (further information from CESR on actual failings of the current regime are welcome). It is also likely that the administrative process involved will irritate clients who are already classified and complained of the administrative side of MiFID when it was implemented and/or consider themselves as seasoned investors.

In our opinion, a more effective solution would be to limit the list of *per se* professional clients to those for whom there is no doubt that they have the necessary experience and knowledge. As entities who are authorized or regulated should naturally meet this requirement, as well as national and regional governments (point I. 1. (3) of annex II) and other institutional investors (point I. 1. (4) of annex II), CESR's concern most certainly lies with large undertakings (point I. 1. (2) of annex II). One way to ensure these actually meet the knowledge and expertise required to qualify as professional clients could be to raise the current criteria of size to ensure only truly large undertakings are within scope.

Q 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?

The FBF does not think so - see its answer to question 6.

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

AMAFI does not think that the client categorisation rules should be changed in relation to OTC derivatives and other complex products and, more generally, it does not think that client categorisation should be based on products.

This would create different types of eligible counterparties and professional clients depending on the underlying products, requiring different approaches. From an

organizational point of view, it would be extremely difficult to handle this complexity properly, requiring sales staff, for a same client, to provide different information depending on the product/client category concerned.

Similarly, clients would have to understand that they are not classified the same depending on the product concerned. For example, when the implementation of MiFID has resulted in classifying some clients in different categories depending on the financial instruments concerned, several firms reported that it has proved difficult for their clients to understand this dual categorisation and that it has created a negative perception of their firm's assessment process. As already mentioned, investment firms should be able to draw up procedures that are understandable and workable for their staff and their clients, something that this proposal will render very difficult to achieve, increasing firms' regulatory risk.

More specifically, and putting this issue aside that applies across the board, the four ideas proposed by CESR raise the following additional comments.

- 1st idea: no ECP status available for transactions in highly complex products

Apart from the fact that eligible counterparties, by nature, should know when they are lacking information or when they need protection, another issue created by this approach is that it assumes that the concept of "highly complex products" be defined, which will be extremely difficult to do.

Indeed, the same product often has different risk profiles depending on the circumstances in which it is used making it almost impossible to create a generic list of very complex (or risky) products adapted to any client. Also, there is no obvious connection between the ideas of "complex" and "risky": the complexity of a product is often not linked to its risk profile and many complex products are designed specifically to reduce risk.

The FBF therefore sees great danger in the perverse effect this proposal could have on the availability of tailored products to sophisticated clients. The FBF still strongly believes that the risk-approach, as regards the products, is far more efficient and relevant than the –complexity-approach.

- 2nd idea: a super ECP status for highly complex products

As the FBF opposes the creation of a "highly complex products" category, it does not seem relevant to create a "super ECP" status.

- 3rd idea: undertakings would need to make a request to be considered as ECPs and firms would have to consider their expertise, experience and knowledge in highly complex products

Please see FBF's answer to question 6

- 4th idea: 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 should treat that investor as a professional client for the relevant transaction

This approach is not acceptable because it overturns the responsibilities of a professional (the ECP) and the firm.

In addition, it rests on very subjective notions and would be tricky to implement, commercially speaking; as it would require the firm to explain its client that it is not as sophisticated as it may think.

Q 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.

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

The FBF obviously supports the principle that firms should act with honesty in their commercial dealings but the proposal raises questions. As CESR admits (see § 37 of the consultation paper), 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 because they are deemed to be able to look after their own interests.

CESR believes that it is necessary though to make it explicit, via new provisions in MiFID, that in dealings with ECPs, investment firms have to act honestly, fairly and professionally. But article 25 of MiFID already sets up this standard, irrespective of the category of clients concerned, with the objective to promote the integrity of the market: *“Member States shall ensure that appropriate measures are in place to enable the competent authority 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”*.

In § 39 of the consultation paper, CESR admits that this provision is not limited to retail and professional clients. And article 24 of MiFID related to transactions with ECPs does not exclude this provision. So, investment firms already have the obligation to act honestly, fairly and professionally and in a manner which promotes the integrity of the market, whatever the type of client they are dealing with, including ECPs. The FBF therefore believes that it is unnecessary to add this specific obligation on firms in relation to dealings with ECPs.

If this proposal was to fill a gap (which one?), CESR would need to provide more information so that one can appreciate the consequences this would have on firms compared to the existing obligation, i.e. several questions would need to be answered :

- Is the change aiming at some misbehaviours that cannot be caught today and if so which ones?
- What new obligations on firms would this trigger?
- What would it change in terms of differences between ECPs and other clients?

Regarding CESR's proposal to make clear that investment firms should communicate with ECPs in a way that is fair, clear and not misleading, here again, the FBF believes it is unnecessary because it is already included in the general principle set in article 25 of MiFID.

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

See answer to question 10.