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**COMMUNICATION FROM THE COMMISSION**

**THE APPLICATION OF CONDUCT OF BUSINESS RULES UNDER ARTICLE 11  
OF THE INVESTMENT SERVICES DIRECTIVE (93/22/EEC)**

## COMMUNICATION FROM THE COMMISSION

### THE APPLICATION OF CONDUCT OF BUSINESS RULES UNDER ARTICLE 11 OF THE INVESTMENT SERVICES DIRECTIVE (93/22/EEC)

#### - EXECUTIVE SUMMARY -

Integrated and efficient EU financial markets are of central importance both for the proper functioning of the European economy as a whole, and more particularly for the shift to a knowledge-based economy. “Facilitating the successful participation of all investors in an integrated market” was listed as a priority by Heads of State and Government at Lisbon. This Communication contributes to that aim. The Financial Services Action Plan identified one potential barrier to such participation as uncertainty over how exactly the provisions of Article 11 of the Investment Services Directive<sup>1</sup> should be applied in practice. The present Communication is set in the broader context of the broad consultation exercise on the shape of possible formal amendments to the ISD.<sup>2</sup>

The context in which this provision is applied has undergone marked changes in recent years:

- New types of investor are present in securities markets.
- Investment firms are developing new technologies in order to serve growing interest in and demand for a wider range of investment products.
- The Directive on certain legal aspects of e-commerce will enter into force at the end of 2001. This will pave the way for a shift to “country of origin” approach as regards the rules – including conduct of business – applied to electronic provision of investment services to professional counterparties.
- The creation of the Forum for European Securities Commissions (FESCO) allows national securities supervisors to co-operate as never before leading to progressive alignment of supervisory practices. This has been shown in the informal consensus reached on the categorisation of investors for the purposes of Article 11.

The present Communication provides a survey of the way in which Article 11 has been implemented in Member States and provides orientations on how conduct of business rules could be applied so as to facilitate cross-border provision of services.

#### On current implementation:

- Member States have taken steps to give legal effect to conduct of business rules in line with the principles of Article 11(1). The basic legal provisions have been supplemented by

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<sup>1</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141/27, 11/6/1993

<sup>2</sup> Commission Communication: Upgrading the ISD. (08.11.00)

detailed rules for enforcement of conduct of business protection. While Member States have differed in the detailed content and form of implementation, national conduct of business regimes offer an equivalent level of conduct of business protection for professionals insofar as they enable expert investors to reach informed decisions about the nature of proposed services;

- The general requirement to distinguish professional from other investors is reflected in most implementing legislation. However, practical implementation of this distinction varies considerably between Member States with the result that investment firms may be classified differently for the purposes of similar transactions in different Member States. As a result, investment firms operating on a cross-border basis may be subjected to qualitatively different business conduct requirements.
- Member States use different tests to determine “where the service is provided” in accordance with Article 11(2). In practice however, these tests are disregarded in favour of an approach whereby domestic conduct of business rules are applied to incoming investment services even though the country of the service provider itself enforces an equivalent level of conduct of business protection.

For the above reasons, cross-border provision of investment services is thus unnecessarily complicated and made more costly than necessary by legal uncertainty and overlapping regulatory requirements. If securities markets are to be successfully integrated, as Heads of State and Government intend, greater convergence in the application of conduct of business rules is essential. In particular, a coherent and systematic approach which takes account of the professional nature of the investor can make a significant contribution to the realisation of a single market for investment services whilst fully safeguarding investor protection. The Communication suggests that:

- **With regard to article 11(1)**, the obligation of Member States to take account of the professional nature of the investor should not be seen as conditional on the prior harmonisation of the content of the conduct of business protection. FESCO has recently reached agreement on a system for categorising investors which provides a consensual basis for identifying and supervising “professional investors”.
- **With regard to article 11(2)**, the general good requires that national supervisory bodies take account of the nature of the investor and their “need for protection” before deciding whether to impose local conduct of business rules. The professional nature of the investor can help to determine whether the imposition of host country conduct of business rules is a proportionate response to the investor’s “need for protection”. Account must also be taken of the fact that conduct of business regimes in all Member States already offer sufficient and comparable protection to professional investors. Therefore, investment services provided to professional investors could be governed exclusively by the conduct of business rules in force in the country of the service provider (“home country”) without prior harmonisation. With respect to retail investors, differences persist between national conduct of business protection : host country authorities may thus impose local business rules for such investors in accordance with Treaty principles and secondary legislation.

The Communication also considers the application of conduct of business rules to branches of investment firms. Effective supervision of conduct of business rules will be enhanced by proximity between the supervisor and the part of the firm dealing with the client. This suggests that the authority of the country where the branch is located may be better placed to police the branch-client relationship. Both the “general good” and provisions of the ISD

provide support. This conclusion is valid for investment services provided by the branch to both professional and retail investors.

If implemented systematically, the approach outlined could facilitate the cross-border service provision to professional investors without amending the ISD. However, legal certainty and clarity would be further enhanced by making appropriate changes to the text of the ISD. Wider consultation on a comprehensive modernisation of the ISD has been launched by the parallel Communication on upgrading the ISD. The analysis of the present Communication can be regarded as a first step in developing an approach which the Commission will seek to integrate in future formal revisions of the ISD. It serves to inform the European Parliament, national authorities, supervisors and market practitioners as to the possible nature of formal amendments to Article 11 and related provisions. The present Communication does not impose any new obligation on Member States, nor does it prejudge the interpretation that the Court of Justice might place on the issue.

# - COMMUNICATION OF THE COMMISSION -

## I. INTRODUCTION

This Communication has been prepared in response to the Financial Services Action Plan<sup>3</sup> which was endorsed by the Cologne and Lisbon European Council Conclusions. The Lisbon European Council identified as a priority task “the successful participation of all investors in an integrated market”. This Communication will contribute to this objective by stimulating competitive cross-border inter-professional business.

The Investment Service Directive<sup>4</sup> (“ISD”) is the cornerstone of the EU legislative framework for financial markets. It serves several objectives. One of them is to provide investment services providers with a single passport for investment services. All Member States have adopted national provisions to implement the ISD. However, experience since the adoption of these measures has revealed a significant degree of uncertainty surrounding the application of Article 11, which contains a number of principles which Member States are required to respect when implementing conduct of business rules.

The context in which the rules must be applied has also undergone marked changes in recent years owing to technological developments and the increased involvement of new types of investor in securities-based investment. The surge in the numbers of investors who wish to participate directly in securities-based investments is placing new demands on current supervisory traditions and resources.

Furthermore, the legal landscape relating to the cross-border electronic provision of services is being clarified. In particular, the Directive on Certain Legal Aspects of E-Commerce<sup>5</sup> implies that the law applicable to interprofessional business investment services falling within the scope of the Directive is that of the country of origin. This directive will take effect immediately following the entry into force of the Directive on 17 January 2002.

This Communication sets out the Commission’s view on how the application of Article 11 of the ISD could be rendered more consistent with the objective of free provision of services. It suggests how conduct of business protection can be tailored to prevailing market reality and impending changes in the legal environment. The Communication does not impose any new obligations on Member States, nor does it prejudice the interpretation that the Court of Justice might place on these matters. However, it outlines a possible orientation for overcoming one of the main stumbling-blocks to the operation of the ISD. Future adjustments of the ISD and Community policy in this area will seek to give full legal effect to this approach. In

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<sup>3</sup> COM(99)232, 11.05.99.

<sup>4</sup> Dir. 93/22/EEC – OJ L 141 of 11 June 1993, page 27.

<sup>5</sup> Adopted on 6<sup>th</sup> June 2000.

doing so, the Communication foreshadows a potentially important contribution to growth, employment and the performance of European securities markets.

## II. INTRODUCTION TO ARTICLE 11 OF THE ISD AND CONDUCT OF BUSINESS RULES:

The ISD paves the way for investment firms in one Member State to provide the same range of services in all other Member States once they are authorised by their home country supervisor.<sup>6</sup> This right may be exercised either through branching or through the cross-border provision of services. In order to underpin the “single passport” for investment firms, the ISD and related legislation contains common provisions governing the operating conditions for investment firms.<sup>7</sup> Article 11, relating to conduct of business rules, is one of the core provisions in this regard.

### *Article 11(1): Conduct of business rules*

Article 11(1) requires Member States to enforce conduct of business rules which investment firms must respect at all times. In essence, these conduct of business rules:

- govern the relationship between the investment service provider and the individual client to ensure fair dealing and that investors are not invited to acquire investments unsuitable for their needs;
- ensure that the investment firm is managed and behaves in such a way as to maintain the integrity of the markets.
- Article 11(1) does not prescribe, in detail, the content or structure of conduct of business regimes in Member States. Instead, it confines itself to a statement of general principles which should inform such regimes. [cf. Insert 1].

### ***Insert 1: Overview of Conduct of Business Rules:***

Conduct of business rules seek to preserve investor confidence and market integrity by setting standards for the performance of activities by investment service providers. The rationale for these safeguards is that there is a danger that certain investors may be disadvantaged by their lack of access to, or capacity to correctly process, financial information.

In particular, service providers are required to:

- act honestly and fairly, with due skill, care and diligence, in the best interest of the client and the integrity of the market. This involves obtaining from their client, information regarding their financial situation, investment experience, and objectives (e.g. the “know your customer” discipline);

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<sup>6</sup> “Member States must ensure that there are no obstacles to prevent activities that receive mutual recognition from being carried on in the same manner as in the home Member State, as long as they do not conflict with laws and regulations protecting the general good in that Member State” (ISD recital no. 33).

<sup>7</sup> The competent authorities of the home Member State are responsible for the ongoing supervision of the compliance of the investment firm with these prudential rules (see Article 8), as well as with many of the disciplines used to police the ongoing activities of investment firms (Article 10).

- make adequate disclosure of relevant material information in their dealings (e.g. risk warnings);
- try to avoid conflicts of interest and, when they cannot be avoided, ensure that their clients are fairly treated.

Article 11 also requires investment services providers “to comply with all regulatory requirements [...] so as to promote [...] the integrity of the market.” This category of conduct of business rules covers measures designed to combat market manipulation and other unfair trading practices. These do not fall within the scope of conduct of business rules governing the relationship between the service provider and the client which are the focus of this Communication.

#### ***Article 11(1): the professional investor***

Article 11(1) requires national authorities to “take into account the professional nature of the person to whom the service is provided” for the purposes of implementing conduct of business rules. Recital 32 of the Preamble of the ISD makes clear that measures undertaken in pursuit of the objective of investor protection should take account “of the different requirements for protection of various categories of investors and of their levels of professional expertise”.<sup>8</sup> Taken together, ***these provisions indicate that conduct of business protection should make allowance for the fact that certain investors need less regulatory protection by virtue of acquired professional expertise or resources.*** These investors are able to reach an informed understanding of the commercial and legal profile of a proposed investment.

#### ***Article 11(2): enforcement of business rules***

In the absence of fully harmonised conduct of business rules, Article 11(2) recognises that responsibility for implementing and enforcing conduct of business rules falls to the competent authority of “the country where the service is provided”.

#### ***Article 11(3): nature of final investor***

Article 11(3) requires that investment firms which are executing orders placed by another ISD firm on behalf of a third party are required to assess the nature of the final investor for the purposes of applying appropriate conduct of business protection.

#### ***Related provisions of ISD***

The ISD contains other provisions which govern activities which are closely related to, or partially overlap with, conduct of business rules.

- Article 10 sets out the prudential rules which home Member States are required to enforce in respect of their authorised ISD firms. These rules enumerate organisational measures which authorised firms are required to implement in

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<sup>8</sup> Recitals to a Directive serve as an aid to interpretation insofar as they shed light on the intentions of the Community legislator. Cf. ECJ Case 76/72 *Michel* [1973] ECR 457 and Case C-238/94 *Garcia* [1996] ECR I-1673.

order to protect investors interests. These requirements related to administrative and accounting procedures; safeguarding the ownership rights of investors; preventing the use of investor funds for the firm's own account; and record-keeping requirements. These safeguards serve the same objectives as Article 11. There is therefore complementarity and overlap in the application of Articles 10 and 11. This interaction is rendered more complex by attribution of responsibility under Article 10 to the home country supervisor<sup>9</sup> whereas Article 11 is less clear as regards allocation responsibility.

- Article 13 authorises investment firms to advertise their services through all means of communication in other Member States “subject to any rules governing the form and the content of such advertising adopted in the interest of the general good”. Despite this separate provision for advertising of investment services, many Member States have included provisions on advertising in their conduct of business regime. Again, this can lead to the same activity being subject to overlapping provisions of the ISD which provide for different approaches.<sup>10</sup>

### III. APPLICATION OF ARTICLE 11 BY MEMBER STATES:<sup>11</sup>

- **Requirement to implement conduct of business rules (Article 11(1))**

Member States have adopted detailed national provisions with a view to enforcing the general principles of Article 11. They have introduced conduct of business rules to protect consumers and investors which cover:

- Advertising, marketing and canvassing (often supplemented by general consumer protection provisions);
- Information to customers (such as periodic disclosure and risk warnings);
- Information from the customer for the purposes of “suitability” test;
- Commissions, charges and fees;
- Fair dealing requirements such as “best execution”.

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<sup>9</sup> With the exception of proviso permitted in Art. 10, 5<sup>th</sup> indent, relating to right of host country authority to impose organisational requirements for limiting conflicts of interest on branches within its territory.

<sup>10</sup> Some of the uncertainty in this area could be resolved by the Directive on the distance marketing of financial services now under discussion in the Council and the Parliament. The proposal could lead to harmonisation of the national rules on the marketing and advertising of investment services, as well as other provisions relating to prior information and marketing techniques.

<sup>11</sup> This analysis is based on replies to a comprehensive survey of national practices in the implementation of conduct of business rules which was co-ordinated by FESCO, complemented by Commission analysis of national implementing laws.

In addition, most Member States implement comparable safeguards relating to the separation of activities to avoid conflicts of interest, and internal controls to ensure due care and diligence. Finally, almost all Member States require the use of written customer agreements and standard documentation. Nevertheless, some differences exist in the practical and detailed implementation of approaches for investor protection.<sup>12</sup>

- **Requirement to take account of professional nature (Article 11(1))**

So far national authorities have taken very different approaches to the way in which they distinguish between professional and other investors. There are differences in the precise boundary drawn between professional and other investors; the procedures used for allocating investors between the two categories, and the content of the protection offered to different types of investors.

Few Member States have expressly differentiated, in implementing law or administrative guidance, between the specific conduct of business protection that should be offered to professional and that to be provided to retail investors. The national provisions of these Member States generally (though not always systematically) indicate which conduct of business requirements can be relaxed or waived in the case of services provided to professional investors. Even in these States, there is still some uncertainty at the margins as to whether a non-financial corporate or expert investor should be treated as a professional or retail investor. Most other Member States rely primarily on general statements, in law or administrative circular, to give effect to the need to take account of the professional nature of the investor.

Member States have also differed in the extent to which they allow investors to opt for less stringent conduct of business protection, whilst several Member States have tailored their conduct of business protection to the type of service or financial instrument in question.<sup>13</sup> This functional or product approach has had a similar effect to differentiation by client type insofar as the nature of protection is modified to take account of the fact that trading in some specific instruments is the preserve of expert investors often subject to prudential requirements.

*The principle that conduct of business protection should differentiate between professional and retail investors has therefore been widely transplanted into national law or administrative practice. However, Member States have implemented this distinction in different ways so that the same investor undertaking a similar transaction could be classified differently depending on the jurisdiction.*

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<sup>12</sup> While there is a shared understanding that “best execution” amounts to an obligation to obtain the best price reasonably available for the client, Member States differ in terms of the procedures used to give effect to this objective. For example, Member States place different emphasis on prevention of conflict of interest, prohibition of activities such as churning, prescriptive rules on order and time limits, allotment and information disclosure. Member States also take a different approach to the extent to which “execution only” business is subject to the full set of conduct of business rules with some Member States admitting less demanding protection for this type of business.

<sup>13</sup> Accordingly, customised conduct of protection are implemented in a number of Member States in respect of corporate finance, derivatives, government bonds, warrants.

- **Responsibility for implementation and supervision (Article 11(2))**

Member States employ a range of different criteria to determine the point at which the service is provided for the purposes of determining which national conduct of business regime is applicable. These tests range from tests based on the country of residence of the investor, through solicitation tests to “characteristic performance” (based on an assessment of where the intermediary employs the resources for carrying out the service). Other Member States operate a case-by-case approach.<sup>14</sup>

In practice, most Member States apply their domestic conduct of business protection to incoming cross-border investment services, without regard to the nature of the investment service or the type of client. Application of host country regime occurs whether the service is provided on a temporary basis or a permanent basis. Only two Member States limit the application of host conduct of business protection to cases where services are provided in a regular manner.

De facto, investment services provided on a cross-border basis generally find themselves subject to the automatic application of conduct of business rules in the country of the investor (host country). The application of host country protection is additional to comprehensive and routine enforcement of conduct of business protection in the country of the service provider. Indeed, the home country supervisor is closely involved in overseeing all services provided by firms located on its territory – without distinction between those provided domestically or on a cross-border basis. This is particularly true as regards the requirements needed for the reconstruction of contested transactions (audit trails) and record-keeping.

*The present situation therefore entails the widespread application of two sets of national conduct of business protection to any given cross border transaction, whether professional or not.*

- **Application of the “look through” requirement of Article 11(3)**

Two Member States have implemented a strict interpretation of article 11(3), requiring that all intermediaries involved in a multiple transaction are required to take account of the nature of the end-investor. Seven Member States restrict the requirement to ‘know your customer’ to the firm which has a direct relationship with the client, unless this firm discloses the identity of the investor to its counterparty. Other Member States have not yet adopted specific rules on this matter.

It is not clear how the “look through” requirement is operated when more than one conduct of business jurisdiction is involved. Three Member States require systematic information about the nature of the end-client by all intermediaries involved, regardless of the country of residence of the client. In the case of another Member State, the “know your customer requirement” is relaxed to allow the investment firm to rely on information about the client supplied by another intermediary or proof.

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<sup>14</sup> This patchwork of approaches could give rise to situations where a given transaction is subject either to two sets of protection (home country operate a characteristic performance test, host country operates a client residence test) or none at all (host country of investor operates a characteristic performance test while home country of service provider operates an intermediary residence test).

- **Implementation of Article 11 - Conclusions**

The Commission's analysis of current national practices for the implementation of conduct of business rules reveals that:

- There are divergences between Member States in the level of conduct of business protection offered to retail investors. These differences seem to be most marked in the areas of "best execution"; conflicts of interest and conduct of business requirements for "execution only" transactions; the typology of contract terms; and documentation. However, with respect to professional investors, national legislations result in comparable protection.
- The general requirement to distinguish professional from other investors is reflected in most implementing legislation. However, there is widespread diversity in the practical implementation of this distinction.
- The drafting of Article 11(2) leads to the use of different tests by different Member States to determine "where the service is provided". In practice however, these tests are disregarded in favour of a rule of thumb whereby domestic conduct of business rules are applied to incoming investment services. These rules are applied even though the country of the service provider itself enforces important, other comparable and equivalent, elements of conduct of business protection.

#### **IV. THE BENEFITS OF THE PROFESSIONAL/RETAIL DISTINCTION FOR THE SINGLE SECURITIES MARKET**

An effective differentiation between professional and other investors could have significant benefits in the form of :

- **Integrated and liquid securities markets and competitive service provision.** The foremost objective of EU legislation in the securities field is to enable investment firms to provide services throughout the EU without being confronted by unnecessary barriers. This will also enable investors to seek out and capitalise on more profitable investment opportunities. The potential duplication of conduct of business protection for cross-border transactions results in market access barriers which prevent counterparties from concluding beneficial cross-border deals and therefore fragments the market, damaging liquidity.
- The application of conduct of business protection, which were designed with the retail investor in mind, to professional investors **increases costs** and may limit their use of innovative products. Significant costs also come from the legal uncertainty over the classification of investors. The current situation maximises this uncertainty and litigation risk by requiring investment firms which make active use of the single passport to comply with up to 15 sets of conduct of business rules. Indirectly, this favours the strongest firms who have the most resources to manage complexity.

**More efficient use of supervisory resources.** Supervisory resources are a scarce commodity. To be best used, they need to be targeted on those parts of the market which can most benefit from them, namely the household or retail investors. Less

protection is required for professional investors who are sufficiently familiar with the market to look after their own interests or obtain investment advice.

## V. **TAKING ACCOUNT OF THE PROFESSIONAL/RETAIL DISTINCTION (ARTICLE 11(1)).**

Article 11(1) contains a clear and unconditional requirement on national authorities to distinguish between professional and other investors for the purposes of implementing conduct of business protection. *The obligation for Member States to take account of the “professional nature” of the investor is not conditional on the prior harmonisation of the content of the conduct of business protection.* National authorities could move now to differentiate the conduct of business regime applied for professional investors.

National conduct of business regimes in force in all Member States already provide for comprehensive conduct of business protection which is sufficient to allow professional investors to make informed investment decisions. Further work is required to refine and clarify the application of the principles of Article 11(1) for retail investors.<sup>15</sup> The fact that work on the appropriate protection to be afforded to retail investors is still ongoing should not be an impediment to the immediate implementation of a distinction between professional and retail investors which takes existing national systems as a starting-point for treating professional investors.

The ISD does not provide a clear definition of “professional nature”. This has led to the proliferation of national approaches for classifying investors. Recently, however, national securities supervisors meeting in the Forum of European Securities Commissions (FESCO) have agreed a common definition for categorising professional investors.<sup>16</sup> They have undertaken to make “best endeavours” to ensure that this categorisation is made operational for all investment services within their remit (domestic and cross-border).

*The Commission considers that national authorities could usefully consider early and effective steps to implement the arrangements that their supervisors have agreed within FESCO.*

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<sup>15</sup> National securities supervisors, working within FESCO, have established a working group on standards for the harmonisation of conduct of business rules. This important work is aiming to achieve consensus on a series of standards including dealing requirements, information to be obtained from clients, information provided to clients, use of customer agreements and documentation.

<sup>16</sup> “Categorisation of investors for the purpose of conduct of business rules”: March, 2000.

***Insert 2: Overview of FESCO classification:***

***Category 1. Investors who are considered professionals without further formality or check. This exhaustive list covers entities required to be authorised/regulated to operate in financial markets including.:***

- Credit institutions (as defined in the Second Banking Directive);
- Investment firms;
- Other authorised or regulated financial institutions (as defined under Article. 1(6) of the Second Banking Directive);
- Insurance companies;
- Collective investment schemes and their management companies;
- Pension funds and their management companies.

*Sovereigns, international/supranational organisations.*

Procedural considerations: Any investor in this category can request treatment as non-professional (opt-up to higher protection).

***Category 2: Investors who may be treated as professional on request.***

*Large and institutional investors incl.*

- Other financial institutions (not covered by Article 1(6) of the Second Banking Directive);
- Large companies and partnerships (certain thresholds);
- Institutional investors other than those which are professionals whose corporate purpose is to invest in financial instruments.
- Commodity dealers;
- Public sector bodies;
- Issuers of listed instruments.

Procedural considerations: The investor must be informed in writing of protections to be conceded and must confirm in writing that they are aware of consequences of losing these protections.

***Category 3: Other investors which may be treated as professional on request:***

These may be allowed to waive some of the Conduct of Business rule protection subject to a detailed assessment of expertise, experience of client (FESCO suggest use of fit and proper test for financial management.). This system is designed to allow expert or sophisticated individual investors to be treated as professional. Two of the following criteria must be satisfied:

- 10 transactions at significant size per quarter over four quarters ;
- size of portfolio greater than 0.5m euro
- 1 year professional experience in sector.

Procedural considerations: the investor must:

1. state in writing that they wish to be treated as a professional.
2. receive warning from investment firm of protections and rights that they may lose;
3. state in writing in a separate document that they are aware of the consequences of losing such protection.

These definitions may call for review in the future. Experience with the agreed classification will highlight ways in which it can be adapted to accommodate new electronic-based systems for performance of investment services, and increased sophistication on the part of clients as they accumulate experience in dealing on securities markets. Any future review could give consideration to broadening the category of category 1 investors as defined by FESCO to include other financial institutions and large corporations which possess treasury departments. Another avenue for the future may be to streamline the opt-up/opt-down mechanisms.

## **VI. ARTICLE 11(2): A POSSIBLE APPROACH FOR CLARIFYING THE APPLICABLE REGIME:**

Article 11(2) provides that “without prejudice to any decisions to be taken in the context of the harmonisation of the rules of conduct, their implementation and the supervision of compliance with them shall remain the responsibility of the Member State in which a service is provided”. In the absence of clear guidance as to determination of “where the service is provided”, national competent authorities have tended to enforce local conduct of business rules on investment services provided to investors located in their territory. Investment service providers are therefore submitted to comply with the dual application of the rules of conduct of the home and the host country.

This situation can be examined by reference to underlying Treaty principles relating to the freedom to provide services (which is the overarching objective of the ISD), specific provisions of the ISD which admit of the application of the general good and related case-law of the European Court of Justice.<sup>17</sup>

The Treaty and the drafting of the ISD establish a clear general presumption in favour of the free provision of services on the basis of home country authorisation. Recital 3 of the ISD makes it clear that the objective of the Directive is “[...] to secure the mutual recognition of authorisation and of prudential supervision systems, making possible the grant of a single authorisation valid throughout the Community and the application of the principle of home Member State supervision.”<sup>18</sup>

However, relevant provisions of the ISD explicitly admit the involvement of host country authorities in the interest of the “general good”. Recital 33 provides “that Member States must ensure that there are no obstacles to prevent activities that receive mutual recognition from being carried on in the same manner as in the home Member State, as long as they do not conflict with the laws and regulations protecting the general good in force in the host Member State”. Articles 17(4) and 18(2) of the ISD provide that the host country authorities, which receive notification from an investment firm from a partner country wishing to establish or provide

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<sup>17</sup> “... when the wording of secondary Community law is open to more than one interpretation, preference should be given to the interpretation which renders the provision consistent with the Treaty rather than the interpretation which leads to it being incompatible with the Treaty. Consequently, the Directive should not be construed in isolation and it is necessary to consider whether or not the requirements in question are contrary to the above mentioned provisions of the Treaty and to interpret the Directive in the light of the conclusion reached in that respect.” . (Commission v. French Republic, C-220/83: ECJ 04.12.86).

<sup>18</sup> Recitals to a Directive serve as an aid to interpretation insofar as they shed light on the intentions of the Community legislator. cf. ECJ Case 76/72 *Michel* [1973] ECR 457 and Case C-238-94 *Garcia* [1996] ECR I-1673.

services in its territory, must, if necessary, “indicate to the investment firm the conditions, including the rules of conduct, with which, *in the interest of the general good*, the providers of investment services must comply in the host Member State.” This wording makes clear that:

- The host Member State must notify, in advance, which conduct of business rules are applicable;
- The host authorities which wish to impose local conduct of business rules which are more prescriptive than the minimal harmonisation of principles for conduct of business achieved under Article 11(1) can do so if this is in the interest of the “general good”.

Article 19(6) also permits the intervention of host country authorities to curb irregularities which contravene the “rules of conduct introduced pursuant to Article 11 as well as to other legal or regulatory provisions adopted in the interest of the general good”.

Several ISD provisions suggest extensive residual powers for host country authorities in the enforcement of conduct of business rules within the rubric of the “general good”.

On the other hand, the ECJ has consistently regarded the imposition of national rules, even if on a non-discriminatory basis, as being subject to review under Articles 49 and 50<sup>19</sup>. In this regard, reference can be made to recent case-law (Case Parodi v. Banque Albert de Bary relating to the provision of mortgages in the banking sector: C-222/95 [1997] ECR I-3899), where the ECJ ruled that:

*“[...]in view of the special nature of certain provisions of services, specific requirements imposed on the provider that are attributable to the application of rules governing this type of activity cannot be regarded as incompatible with the Treaty.*

*It must be remembered, however, that as a fundamental principle of the Treaty, the freedom to provide services may be limited only by rules which are justified by imperative reasons relating to the public interest and which apply to all persons or undertakings pursuing an activity in the state of destination, insofar as that interest is not protected by the rules to which the person providing the services is subject in the Member State in which he is established. In particular, those requirements must be objectively necessary in order to ensure compliance with professional rules and to guarantee the protection of the recipient of services and they must not exceed what is necessary to attain those objectives [...]*”

***Article 11 of the ISD admits active role of host country authorities in enforcing conduct of business rules under Article 11. However, the Commission considers that, in exercising responsibilities for the enforcement of conduct of business***

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<sup>19</sup> “[...] Article 49 of the Treaty requires not only the elimination of all discrimination on grounds of nationality against providers of services who are established in another Member State but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, which is liable to prohibit, impede or render less advantageous the activities of a provider of services established in another Member State where he lawfully provides similar services.” (cf. Case Arblade & Leloup, C 369/96 AND c-376/96 [1999] ECR I-8543).

*rules, host country authorities could take into account two related considerations : (1). whether or not the home state of the service provider implements conduct of business rules which offer equivalent protection and (2). whether the imposition of host country rules is a proportionate response to the preserving the underlying ‘general good’.*

- As regards the assessment of “proportionality”, it is necessary to identify criteria which can potentially be used to determine how host country authorities could exercise their powers for the application of domestic conduct of business rules. The Commission considers that one possible criterion in this regard is the “need for (investor/consumer) protection”<sup>20</sup>.

The focus on “need for protection” is also supported by reference to other EU legislation in the investment services/securities field.<sup>21</sup> Investors – or their advisors – have to make their own assessment as to the particular features of the proposed investment. Conduct of business rules only seek to ensure that investors are not induced to undertake unsuitable investments and to protect investors against abuse and misconduct. Legislation in the investment services/securities area is therefore heavily centred on the principles of disclosure of information to enable rational investors to reach informed decisions.

*In the light of the above, the “need for protection” is one possible criterion which can be used by host country authorities when required to assess whether the application of its conduct of business rules is “proportionate.*

### **1. Protection of professional investors:**

Expertise and the ability to act in one’s self-interest are the critical factors in establishing the “need for protection”. Where the investor is professional in nature, it may be argued that he/she possesses the capacity and expertise to make informed or educated investment decisions.

Such an approach has been suggested by the European Court of Justice in its jurisprudence. In particular, the Court has recognised that measures which aim to protect the weaker party in a contract cannot be considered to fulfil the general good

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<sup>20</sup> This is the underlying rationale for the conduct of business rules under consideration. It is also a unifying principle of the ISD which finds clear expression in a number of provisions: Recital 32 which states that in the enforcement of investor protection, it is “appropriate to take account of the different requirements for protection of various categories of investors and of their level of professional expertise”.

As demonstrated above, the conduct of business rules as required under Article 11(1) are motivated by the need to ensure appropriate protection and fair dealing with the client.

Article 14(4) requires Member States to take account of investors’ differing needs for protection and in particular the ability of professional and institutional investors to act in their own best interests when deciding whether investors should be eligible for the exemption from the requirement to complete transactions on a regulated market under Article 14(3).

<sup>21</sup> In this regard, the Investor Compensation Scheme Directive (97/9/EEC) is particularly instructive. This Directive provides that certain categories of professional and institutional investor can be exempted from the scope of mandatory investor protection schemes provided for in the Directive (Article 4(2)) “if it does not consider that they need special protection from the cover afforded by investor-compensation schemes.” (recital 17). The Investor Compensation Scheme Directive clearly revolves around the “need for protection” philosophy.

test where the counterparty is a professional operator.<sup>22</sup> This reasoning is predicated on the absence of a “need for protection”. The same reasoning may be useful in the case of professional investors. In related case-law in the insurance field, the ECJ has applied a reasoning which recognises that professional or expert agents require less protection than retail consumers (C-220/83). Similar reasoning informed important elements of the ECJ’s reasoning in the Alpine case (C-384/93) where it supported application of more stringent provisions to the marketing/advertising of derivatives-based investments to retail investors.

***The distinction between professional and retail investors which Member States are required to use under Article 11(1) is potentially relevant for clarifying the extent to which the investor “needs” the protection offered by host country conduct of business regime in addition to that offered by home country rules. The “proportionality” test may be harder to satisfy in respect of professional investors given that the latter require less protection.***

The possibility that the needs of professional investors are guaranteed by home country conduct of business rules is reinforced by the finding that all Member States seem to implement sufficient and comparable protection to professional investors. As shown above, all national regimes provide sufficient safeguards to enable expert/professional investors to make informed investment decision and to take any steps to secure their commercial interests.

The benefits of home country protection extend fully to firms which are active in other Member States. This is because, prior to undertaking a transaction with a partner country client, the investment firm will need to establish the identity of the counterparty and perform the necessary suitability tests. This in turn will trigger automatic application of important elements of the home country conduct of business regime (record-keeping, disclosure, best execution) which can be most effectively policed and enforced through the offices of the home country authority.<sup>23</sup>

The following practical considerations should also be borne in mind:

- Practical arrangements which are in widespread use (Master Agreements and other codified agreements) provide professional investors with a contractual basis to resolve any grievances against counterparties in a timely and cost-effective manner.
- the Directive on certain legal aspects of e-commerce which is to enter into force in January 2002. This Directive is intended to create a legal environment which encourages the development of e-commerce in Europe. Its guiding philosophy for investment services is that any service which is provided electronically will be governed by the applicable law of the ‘country of origin’. This result will apply without qualification to business-to-business or inter-professional dealings but will not apply to contractual obligations arising from consumer contracts.

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<sup>22</sup> C-205/84 Commissioner v. Federal Republic of Germany.

<sup>23</sup> The position of the Advocate-General in the Alpine case (C-384/93) is noteworthy in this regard. The AG stated that “the Member State from which telephone call is made is best placed to regulate cold calling. Even if the receiving State wishes to prohibit cold calling or to make it subject to certain conditions, it is not in a position to prevent or control telephone calls from another Member State without the cooperation of the competent authority of that State.”

*For the above reasons, the Commission considers that national conduct of business regimes can be deemed to offer adequate and equivalent protection to professional investors. In the light of the above, the Commission considers that national competent authorities could consider waiving host country conduct of business rules to cross-border investment services provided to locally domiciled professional investors.*

***Insert 3. Which professional investors could be exempted from host country rules ?***

The recently established FESCO agreement on the categorisation of investors for the purposes of Article 11 identifies a core of investors who could automatically be treated as “professionals”. ***Investment services provided to these investors could be governed exclusively by the conduct of business rules in force in the country of the service provider (“home country”)***<sup>24</sup>.

In addition to this group of “automatic professionals”, national authorities can also decide whether to apply or waive the application of local regime to investors which do not automatically qualify as “professional”. This assessment could again be undertaken in the light of that Member States “general good”.

2. Protection of retail investors:

Given the present fragmented state of contractual and extra-contractual frameworks and enforcement systems, national administrations may have concerns about the exposure of their retail investors to legal uncertainty or counterparty risk. Section III above has highlighted differences in conduct of business protection which prevents these rules from being presumed “equivalent” for retail investors. The application of local business conduct rules applying to transactions involving locally domiciled “retail investors” may therefore improve protection for retail investors.

***Consequently, retail investors need more protection than professional investors. Member States could take this into account when they consider the implementation of Article 11(1) and (11)2 of the ISD.***

This assessment regarding retail investors may evolve in the light of changing market reality and further supervisory co-operation. The development of new business models based on electronic communication and distribution may mean that current approaches need to be changed at a later point. The legal environment for electronic provision of all information services will also change. The way in which national competent authorities co-operate in enforcing conduct of business protection may need to take these developments into account. The Commission also examines these issues in the parallel communication on modernisation of the ISD. They will also be treated in the forthcoming Commission Green Paper on E-commerce and Financial Services.

Another noteworthy development is the way in which, following agreement on a system for categorisation of investors, FESCO is now working on common standards for conduct of business protection. A common understanding on the treatment of

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<sup>24</sup> Investors who qualify automatically as professionals nevertheless retain the possibility of requesting higher levels of protection from their counterparty.

retail investors, may mean that the issue of whether the “general good” continues to require application of host country regime for these investors needs to be re-examined.

### 3. Treatment of branches:

*There are features specific to branch-based investment business which may, in accordance with the Treaty, justify the application of the host country conduct of business regime to all of the client-related functions of the branch. This conclusion is valid for investment services provided by the branch to both professional and retail investors.*

The authorities in the country where the branch is established are best-placed to assume a front-line role for supervising the compliance of both categories of investor. Branches of investment firms in other Member States generally operate customer handling systems which are autonomous from that of the parent country. Supervisors in the country of the branch are on-site, have direct access to audit trail and record-keeping of the branch and are better positioned to check the handling of the direct relationship between the branch and its clients.

This reasoning is consistent with Article 10 (5<sup>th</sup> indent) of the ISD which provides that “where a branch is set up, the organisational arrangements may not conflict with the rules of conduct laid down by the host member State”.

## VIII. CONCLUSIONS

This Communication has reviewed the manner in which Member States implement conduct of business rules as required by Article 11. It has established that:

- while Member States have differed in the detailed content and form of implementation, national conduct of business regimes seem to offer an equivalent level of conduct of business protection for professionals insofar as they enable expert investors to reach informed decisions about the nature of proposed services;
- the general requirement to distinguish professional from other investors is reflected in most implementing legislation. However, practical implementation of this distinction varies considerably between Member States with the result that investment firms may be classified differently for the purposes of similar transactions in different Member States. As a result, investment firms operating on a cross-border basis may be subjected to qualitatively different business conduct requirements.
- Member States apply domestic conduct of business rules to incoming investment services without regard to whether the country of the service provider enforces equivalent conduct of business protection.

The resulting combination of legal uncertainty and overlapping requirements is wasteful and highly disruptive for the cross-border provision of investment services. These costs can be avoided – insofar as inter-professional investment services are

concerned – by a coherent and systematic distinction between professional and retail investors.

Article 11(1) contains a clear requirement on national authorities to distinguish between professional and other investors for the purposes of implementing conduct of business protection. The Commission considers that this obligation is not conditional on the prior harmonisation of the content of the conduct of business protection. While the ISD does not provide a clear definition of “professional nature”, FESCO has recently agreed a common template for categorising professional investors. When taking account of professional nature for the purposes of Article 11(1), national authorities may wish to consider the FESCO agreement on the categorisation of professional and retail investors.

This Communication has also outlined a possible approach to guide host country authorities when exercising their responsibilities for enforcement of conduct of business rules under Article 11(2) and the “general good”. Host country authorities could in particular seek to apply conduct of business requirements in a manner which is proportionate to the concrete need for investor protection. This Communication has put forward some elements to suggest that *professional investors as defined in category 1. FESCO classification who possess the expertise needed to assess the characteristics of a proposed investment transaction can undertake investment services subject only to conduct of business protection of the country of the service provider*. Implementation of conduct of business rules by the home country supervisors offers equivalent protection to this category of investor.

The Communication suggests that retail investors need the protection provided by the application of host country conduct of business rules. The extent to which the application of host country conduct of business protection is a proportionate step for the protection of retail investors may be reviewed if, for example, current FESCO-led efforts to standardise conduct of business protection for non-professional investors leads to convergence of national practices.

The Communication also considers the roles and responsibilities of home and host supervisors in terms of enforcing conduct of business rules on branches of investment firms. Effective supervision of conduct of business rules will be enhanced by proximity between the supervisor and the part of the firm dealing with the client. This suggests that the authority of the country where the branch is located may be better placed to police the branch-client relationship than the supervisor in the country of the parent undertaking. Both the “general good” and provisions of the ISD provide support. This conclusion is valid for investment services provided by the branch to both professional and retail investors.

The application of the distinction between professional and retail investors could facilitate cross-border investment service provision to professional investors without requiring a formal amendment of the ISD. However, legal clarity and certainty argue in favour of formal modification of Article 11 and related provisions of the ISD. The parallel Communication which maps out a comprehensive modernisation of the ISD will be the focus for extensive consultation with national authorities, supervisors and market practitioners over the coming months. The present Communication outlines one possible direction for modification of the ISD. Participants in that consultation process may wish to take account of the analysis put forward in the present document

and their comments and responses to the ISD review could be informed by the preceding analysis.