

CONVERGENCE OF CLIENT CLASSIFICATION REGIMES

The UK proposes a project to facilitate convergence of national client classification systems in financial services law by establishing a number of international paradigms in this field. The proposal contemplates an outcome for the project in the form of a soft-law instrument employing the format of principles and/or definitions. This instrument would represent, on completion, a persuasive international authority defining the categories of client and counterparty with which regulated financial markets entities commonly contract and would be used as a template for legislation and regulation globally, but especially in the emerging markets economies.

Project Justification

In the field of financial services regulation, there is a growing international consensus on the need to draw certain distinctions, for example, between wholesale and retail transactions or between qualified and non-qualified investors, when regulating the conduct of client business by undertakings who engage in the provision of financial products and services. Internationally, legislators and regulators are actively discussing legal and regulatory convergence and its benefits to international capital markets, clients, the cost of capital and more efficient and effective regulation.

The classification of contractual counterparties is also becoming a question of importance in the civil law arena. Choice of law rules for financial contracts which are sensitive to the differing levels of sophistication of the contractual parties involved, are being considered in several fora. A typical example is a special choice of law rule for consumers that provides them with the added protection of their “home” governing law. Although a rule further differentiating categories of consumer according to levels of financial markets sophistication and knowledge has recently been rejected for certain financial contracts in the European context,¹ it is likely that such an approach will be considered again in a legislative context in a national or supranational forum.

In general, it is widely believed that international guidelines or standardised definitions could: develop stable expectations over time and across regions, particularly in emerging markets; improve temporal and geographic legal continuity; ensure a high degree of congruence between market participants’ commercial expectations and their local experience; and, reduce the practical complexities and associated costs for international firms in the conduct of cross-border business.

The project which is proposed – a step towards the international standardisation of investor definitions – would counteract the current trend towards an ever greater array of different national regimes, which exists despite the common functional objectives for classification which most, if not all, legal and regulatory regimes acknowledge themselves as sharing. Although there is a considerable degree of international consensus, particularly among sophisticated economies, on the need for certain distinctions to be drawn between counterparties according to their need for protection, each national legislator or regulator who confronts those distinctions has a tendency to formulate the categories in isolation and to define them according to a range of locally-specific criteria. Moreover, in the case of rapidly emerging economies, where there is enormous pressure to develop a legislative and regulatory framework for the financial markets in a very short time, the benefits of an internationally consistent approach to client categorisation may get overlooked entirely in a bid to implement general rules as rapidly as possible.

This project would give additional impetus to international convergence and the standardisation of national regimes and the financial markets in sophisticated economies would stand to benefit from this in the ways outlined above. However, a number of other benefits could be expected to accrue over time: for example, international definitions might well support progress towards more efficient regulatory recognition between jurisdictions and even facilitate “exemptive” relief in certain respects from the double regulatory burden experienced by foreign firms conducting wholesale cross-border business. These moves would benefit investors and the consumers of financial products and services by facilitating their access to a wider range of those products and services whilst ensuring appropriate regulatory protection. More immediately, perhaps, individual market participants who conduct cross-border business in sophisticated economies could benefit from any definitions put forward by the instrument by incorporating them into their contracts, in the manner of an optional uniform law. Most importantly, however, the instrument that results from the project could serve as a template for emerging economies which have yet to establish a system of investor classification for their own local markets. In so doing, the

¹ During the negotiations of what is now Article 6 of the Rome I Regulation.

principles or guidelines drawn up would make it easier for foreign firms to develop stable expectations about the conduct of business in these economies, thereby facilitating international trade so as to promote global economic development. Greater standardisation would also assist regulators by allowing firms to develop stable expectations with regard to regulatory requirements, thereby facilitating their effective implementation.

Project specifics

Instruments which are soft law in character are much more likely to withstand time and adapt to local market needs and, therefore, also more likely to be easily agreed upon. Two possible formats for the putative investor classification instrument have been considered in the UK scoping exercise for this proposal: the first is a descriptive “Definitions” format and the second is in a “Principles” format, which has already been adopted successfully by UNIDROIT in another context. In fact, research suggests that the project might make use of both these approaches. For example, the draft instrument might set principles broadly requiring national authorities themselves to draw a number of binary distinctions between different types of investor and thereafter, supply one or two of the less politically-sensitive definitions by way of minimum content to substantiate these distinctions. Additional definitions could be provided for use at the option of the relevant national authority. Further details are given below.

The proposed instrument should establish as its core objective the furtherance of global convergence on client classification. This objective entails the key principle that the definitions should be implemented by national authorities in such a way that levels of legal and regulatory control imposed on firms should reflect clients’ differing needs for protection, according to the classification provided. The instrument might also provide a basic description of the types of situation in which the distinctions and definitions provided should apply.

In short, the instrument drafted by experts for member states’ consideration, should adopt an intermediate position between the precision of harmonised definitions and the flexibility of a functional legislative or regulatory guide. Consideration should be given to the preparation of an instrument which will: 1) furnish a basic description of the firms, authorities and transactions to which the instrument is intended to apply and a description of its core objective; 2) require national authorities to observe a distinction between wholesale and non-wholesale business for certain purposes; 3) provide a clear definition of wholesale business; 4) omit any exhaustive or mandatory definition of retail business, inviting or requiring national authorities to draw up their own definition within the category of non-wholesale business; and 5) invite or require authorities to draw further definitions and distinctions, including a distinction between qualified and non-qualified investors, without exhaustively specifying the criteria to be used by the relevant national authority.

A key component to the long-term success and value of such a project would be securing the participation and eventual endorsement of international regulatory authorities and standard-setters. Bodies such as the International Organisation of Securities Commission and the Committee of European Securities Regulators should be invited to attend plenary sessions as observers and to contribute in ways thought to be appropriate.

UNIDROIT

A project of this kind would be best managed by UNIDROIT for two reasons: first, UNIDROIT’s unique working methods, allowing a draft text to be drawn up by technical experts before it is considered in plenary by member states, are particularly appropriate for a technical and market-sensitive project of this kind; and, second, UNIDROIT already has experience in the planning and overseeing of financial markets projects, which it gained during the negotiations on the forthcoming Intermediated Securities Convention.

This project should not prove as challenging as others undertaken in the past by UNIDROIT. Initial scoping work in the UK suggests that much could be achieved in an instrument of only 6 Articles or Principles. Therefore, following the expert preparation of a text, 3-4 plenary sessions are probably required in which a draft instrument could be satisfactorily concluded. The project might be completed in 3 years.

Conclusion

The UK believes that a soft-law instrument encouraging some degree of standardisation, while allowing national authorities to continue to exercise local discretion in key areas, will effectively promote international convergence on investor classification, in both sophisticated and emerging market economies.