

THE FUTURES AND OPTIONS ASSOCIATION

**"DIFFERENTIATED REGULATORY APPROACHES :
FUTURE REGULATION OF INTER-PROFESSIONAL BUSINESS"
FSA Discussion Paper**

A Response by the Futures and Options Association (FOA)

February 1999

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1. INTRODUCTION

- 1.1 The Futures and Options Association (FOA) is the industry association for some 180 firms and institutions which engage in the carrying on of derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks and other financial institutions, commodity trade houses, exchanges and clearing houses, fund managers and firms involved in supplying services into the futures and options sector (see Appendix 1).

In making this response, the FOA would emphasise that most of the business carried on by its membership is wholesale in nature and undertaken with or for professional counterparties.

- 1.2 The FOA's response to the FSA Discussion Paper "Differentiated Regulatory Approaches: Future Regulation of Inter-Professional Business" is made against the following background:

- The Government and the FSA have already recognised the need for a distinctive and appropriate regulatory framework for inter-professional business and wholesale markets and assumes therefore that the issue is not whether such a framework should be provided, but rather more the timing, nature and extent of its provision.
- The FSA shares the industry view that development of a differentiated regulatory approach to inter-professional business is "a high priority" (para 1.4 of the FSA paper).
- The exact scope of the new legislation is yet to be determined and it is not therefore clear at this stage which wholesale markets and what categories of inter-professional business and counterparties will be caught by the FSA's proposals for a differentiated regulatory approach. Depending upon the scope set out in the forthcoming statutory instrument (and the related exemptions), it is clear that, in some professional markets - particularly commodity/energy markets - the concept of inter-professional business applies as much between non-authorized professional counterparties as it does to business undertaken involving an authorised institution.

- The Financial Services and Markets Bill contains a number of provisions which facilitate the adoption of a differentiated regulatory approach to inter-professional business, namely:
 - “in discharging its general functions the Authority must, so far as reasonably possible, act in a way which the Authority considers most appropriate for the purpose of meeting (its) objectives” (Clause 2 (1) (b));
 - “in discharging its general functions, the Authority must have regard to proportionality between the regulatory burden of the intended benefit, the desirability of facilitating innovation, the international character of financial services and markets and maintaining the competitive position of the UK’s financial service sector” (Clause 2(3));
 - in meeting its objective to protect consumers, the Authority must have regard to the degree of risk attaching to particular kinds of investments and other transactions, “the differing degrees of experience and expertise which different consumers may have in relation to different kinds of regulated activity” and “the general principle that consumers should take responsibility for their decisions” (Clause 5(2)) (NB For example, in the case of wholesale/professional counterparties there is no need for “protection” beyond that provided by the existing law);
 - the Authority may endorse a code “as respects a specified kind of authorised person” (Clause 74); and
 - the Authority “may make different provision for different cases and may, in particular, make different provision in respect of different descriptions of authorised person, regulated activity or investment” (Clause 74).

The FOA recognises that the FSA will be very familiar with its powers to adopt differentiated regulatory approaches, but wishes to emphasise the breadth of the discretion given by the Bill to the FSA in this context; that such powers may be exercised in relation to incorporated bodies, partnerships and individuals (i.e. “consumers” as defined in Clause 5(3)); and that the guiding principle underlying the regulation of inter-professional business is that of *caveat emptor*.

1.3 The FOA in its preliminary comments regarding the need to adopt a differentiated regulatory approach to inter-professional business would refer to the recently issued “The Better Regulation Guide” and, in particular, the following statements:

- “important though regulation is, there will be many occasions when alternatives such as codes of practice and economic instruments are a better answer” (Prime Minister’s Forward);

- “alternative forces, such as consumer choice, customer loyalty, competition and innovation may be a faster or more reliable method of solving the difficulties you have identified” ;
- “wherever possible regulation should specify the goal, leaving those who have been regulated some freedom to decide how to achieve this goal” .

1.4 The FOA has already raised its concerns over the use of the term “consumer” to cover wholesale/professional counterparties and the consequential confusion it is already creating in the context of some of the recently issued FSA consultation papers and because of variables in the definition when used by different bodies in different contexts for different purposes (e.g. under EU legislation, the term is commonly used to apply only to individuals acting outside the course of their normal business; and under UK legislation in the case of, for example, the Sale of Goods Act and the Unfair Contract Terms Act).

1.5 In addressing the question as to whether or not consumers/customers should be divided into two categories (i.e. “professional” and “retail”) or three categories (i.e. “professional”, “intermediate” and “retail”), the FOA would instinctively prefer the more straightforward and simpler approach of two categories. However, there is a real risk that the “professional” category, in order to maintain maximum regulatory “lightness” in the regime, may be so narrowly defined as to exclude certain types/sizes of consumers/counterparties which could and should otherwise fall into that category. Alternatively, the degree of “lightness” of the regime for inter-professional business may be reduced significantly if the “professional” category went significantly beyond large-size core commercial and financial institutions. As a result, in answering questions 11, 12 and 13, the FOA, even though preferring the two category approach in principle, has assumed that the “intermediate” regime will be necessary in order to secure the benefits of (a) securing the broadest potential for customers/counterparties to “opt out” of retail regulation; and (b) avoiding introducing any impediments to delivering the lightest possible regime for professional business.

1.6 In relation to **paras 1.4 and 1.5 of the FSA paper**, the FOA supports the FSA’s intention to “maintain an open dialogue with the industry as policy in these areas is developed” and particularly FSA’s initial round of discussions with financial service trade associations. On the other hand, the FOA would be interested to know which FSA practitioner committees have been consulted on these issues in the light of FSA’s statement that it has been doing so “over the past few months” .

Scope

- 1.7 With regard to **para 1.6 of the FSA paper**, the FOA would point out that “commodities” are not themselves “financial instruments”. It is assumed that their inclusion in this context was unintentional, but if that is FSA policy, then that would be a matter of considerable concern to a wide range of commodity houses and institutions. For clarification, while “commodities” may be the underlying property to a financial instrument, they are not and never have been “financial instruments”. On that basis, they are already adequately covered through the use of such general terms as “futures, options (including warrants), swaps, contracts for differences”.

Purpose

- 1.8 With regard to **paras 1.9 and 1.10 of the FSA paper**, the FOA welcomes FSA’s commitment to differentiate in the “regulatory treatment of professional and non-professional business” and its acknowledgement that, in general, “market professionals” operate on the basis of “essentially symmetric information capabilities, expertise and market knowledge”.
- 1.9 The use of the definition “professional” to cover agents, arrangers and certain end-users - in addition to principals - is, in the view of the FOA, the right approach for reasons set out in Q3.

2. DIFFERENTIATION BETWEEN PROFESSIONAL AND OTHER MARKET USERS

- 2.1 In relation to **paras 2.1 and 2.2 of the FSA paper** and in addressing the degree to which *caveat emptor* may be applied to consumers, the FSA is required by the Bill to have regard to “the general principle that consumers should take responsibility for their decisions” and it should be noted that the Bill draws no distinction, in this context, as to the category of “consumer”.
- 2.2 In **para 2.9 of the FSA paper**, the FOA notes FSA’s concern at the prospect that customer categorisation may result in certain customers being misclassified. FOA’s response to this concern is set out in Q9.
- Q1.** The FOA prefers the SFA’s approach to that adopted by the Grey Paper regime and supports therefore FSA’s proposal to define eligibility for inclusion in the framework for inter-professional dealings on the basis of the expertise and experience of the market user and that “product categorisation should not drive the overall framework for professional dealings” (para 2.11 of the FSA paper) for the following reasons:

- the focus on the nature of the customer rather than the nature of the dealings is more in line with the concept of investor protection, the approach of the Investment Services Directive and the Bill's own approach which is customer-based rather than transaction-based;
- SFA's approach, although more onerous in some respects upon the firm, provides for a more flexible approach to counterparty analysis;
- SFA's approach gives due recognition to FSA's view that there is "a full spectrum of expertise" between market professionals and retail customers and allows for customers falling within that spectrum to be classified, where appropriate, for inclusion in the wholesale approach;
- SFA's approach is well-tested and familiar to a large number of institutions and its continuance will help to avoid large scale reclassification;
- size of transactions and (whether corporate or individual) of customers may be relevant to the ability to absorb loss, but is not necessarily an accurate indication of expertise (although it is relevant factor when classifying customers);

Q2. In general terms, the FOA believes that there should be two categories of persons eligible for inclusion within the proposed inter-professional (or as it is described later in the FSA paper the "professional" regime) namely "market counterparties" and other "professional" consumers:

- "Market counterparties" would include (a) "General Market Counterparties" i.e. institutions and firms which are authorised or licensed to carry on financial services business; and (b) "Market-Specific Counterparties" i.e. large-size "professional" counterparties which are not licensed or authorised, but which can nevertheless be treated as market counterparties in particular markets/products (e.g. large-size companies, government bodies, municipal authorities).

Group (a) could be categorised as market counterparties for all purposes (and not just in relation to particular markets or particular products) on the basis that:

- (i) they will have as much familiarity as their authorised counterparties of the process and consequences of classification (and will be undertaking that exercise themselves for their own customers) and of the importance of refusing market counterparty classification where appropriate; and
- (ii) they may always "opt-out" (i.e. elect for a higher standard protection) in relation to the provision of some services (e.g. in the case of fund managers with private investors).

In other words , once the financial service supplier is satisfied that the counterparty is also authorised/licensed and that they have been duly sent a notice of classification (see Q15), the burden should then be upon such a market counterparty to reject classification or to restrict or limit it to certain products and services (i.e. the burden of "opting out" will be on the authorised counterparty).

NB: There is a strongly-held view that large-size "ordinary business investors" can be expected to have sufficient experience and understanding of the implications of being classified as general market counterparties.

Group (b) counterparties, on the basis that they are not licensed or authorised, should only be classified as market specific counterparties where they are (or self-certificate they are) of a certain size or can be deemed "professional" for other reasons (e.g. as having specific and sufficient expertise in particular products, markets or services).

- Small-size corporates could be eligible for inclusion in the proposed inter-professional or "professional" regime, but the process of analysis for this purpose would be significantly more exacting and based on an "opt-in" approach (i.e. some such counterparties may not be eligible for inclusion in the "professional" regime, but may be better suited (as is the case with high net worth investors) to the proposed "intermediate" regime whereby they will be able to "opt out" of certain retail rules (e.g. best execution, segregation)). (See Q11,12 and 13.)

Q3. The FOA believes that every authorised or licensed institution should be automatically categorised as being subject to the inter-professional regulatory regime, notwithstanding that they may be acting on behalf of another customer who may not be eligible for inclusion in such a regime, for the following reasons:

- such an approach is in line with current money laundering requirements and SFA's own approach;
- by imposing the classification obligation on only the "first in line" customer/counterparty, burdensome "look through" obligations as regards dealings with agents acting for undisclosed principals or disclosed, but unidentified, principals are avoided;
- the authorised market counterparty will be fully aware of the implications of being treated as a market counterparty;

- the authorised market counterparty would clearly not be entitled to treat dealings with its non-professional customers as inter-professional business and (a) will itself owe retail duties and protections; and (b) may demand delivery of those protections to it in respect of such business;
- the financial service supplier will still owe retail regulatory protections in the case of retail customers which are disclosed and identified by the agent to the extent that they are direct customers of the firm in question.

Clearly, there may be a need for some degree of “look through” either to meet the commercial requirements of the financial service supplier (e.g. verification of identity, credit analysis) or to meet the regulatory obligations imposed because of the nature of the underlying counterparty/customer (e.g. in the case of retail counterparties/customers, best execution, segregation etc.). So far as the former is concerned, reliance can be placed on an agent to secure the necessary information (subject to, for example, SFA’s rules which set out the circumstances where such reliance may be placed by authorised firms on others as regards the provision of information and the performance of duties); and, in the case of the latter, an agent which owes retail regulatory obligations to its underlying customer will ensure that, where relevant, those duties are delivered to him as agent to that customer by the financial service supplier.

Q4. Yes.

- Q5.**
- Net worth or size of counterparty is a reasonably simple classification, but it is, of course, no guarantee of expertise and is a presumption therefore that is easily rebutted. The FOA prefers FSA’s suggested test of identifying individuals who are “actively managing their own financial affairs”. However, net worth is highly relevant to credit risk and the ability to absorb loss, so it would be reasonable to assume that customer analysis of high net worth investors and large-size counterparties need not be as extensive as might be the case for small-size/low net worth customers.
 - Transactions above a certain size are, as is stated by FSA, wholesale in nature, but that does not necessarily mean that the customer is a wholesale consumer. Moreover, as FSA will know, private investors can now access OTC transactions. The FOA argued strongly for such access on the basis that high regulatory standards imposed on financial service suppliers should be compensated by low investment access restrictions (and equally low regulatory standards on such suppliers should be compensated by a more restricted approach to product access in the case of retail consumers, particularly to complex or risky transactions). Nevertheless, transaction size is a significant factor in determining whether or not, at first sight, a counterparty is a professional counterparty.

While counterparty or transaction size is not an adequate basis for assessment on their own, the combination of a counterparty that exceeds a particular capital threshold who is trading for commercial reasons a transaction which exceeds a certain size, is strong *prima facie* evidence of inter-professional business.

- Relevant criteria for customers/counterparties who are not eligible for automatic classification (see Q2) could include:
 - size of the customer/counterparty;
 - size of the transaction;
 - the nature, duration and frequency of trading;
 - the type and breadth of markets and products traded;
 - the risk/reward ratio of the trading activity and the consumer's response to the outcome of that trading;
 - trading experience of relevant individual staff;
 - once they are aware of the implications, the counterparty's response to classification;

Q6/7. The existing SFA thresholds are known and generally regarded as workable and acceptable - although there may be a case for reconciling the SFA size test with the size test set out in the Compensation Directive.

Q8. The FOA believes that all categories of customer e.g. corporates, public sector bodies and partnerships should be eligible for inclusion in the inter- professional regime and in the market professional category, since the type of counterparty is not a key determinant of experience/expertise. Private individuals would probably, even at their most experienced, be eligible for inclusion in only the "intermediate" regime.

Q9. The FOA recognises that the tests of relevant expertise will be higher in the case of small-size corporates and private individuals, particularly in the context of high-risk transactions, where the risk of loss is high, but it does not accept that risk of incorrect classification should restrict any one type of counterparty from being categorised as "professional" or "intermediate".

It is perhaps inevitable that incorrect classification will sometimes occur, but it is assumed that FSA's principal concern is to ensure that it is not frequent, deliberate or negligent. Accordingly, FSA will wish to be satisfied that firms are using relevant and effective criteria for classifying customers and will monitor firms' performance in so classifying customers. It is perhaps worth bearing in mind that customers will be sent a note of their classification (and its consequences). In line with the statutory approach which recognises the responsibility of customers, it will be as much a matter for customers to ensure that they are not misclassified or, even if correctly classified, do not wish to accept the consequences of that classification (see also FOA's responses to Q15 and Q16).

Q10. The FOA supports a flexible approach and believes that the costs of having a broader definition of "market professional" (i.e. of the sliding scale of depth and detail of analysis which will become more burdensome in the case of, for example, small-size counterparties) will be offset by the benefits of providing less regulatory protections for a broader range of counterparties (and it may not be all of them) who may be included in the lighter regulatory regime.

Q11. This question as to whether most members would prefer to adopt a narrower professional group is difficult to answer because:

- firstly, it is not known whether any such narrowly defined professional group would still be sufficiently broad to capture most counterparties engaging in wholesale business;
- secondly, the establishment of a broader professional group is not, in the view of the FOA, dependent upon establishing higher standards of business conduct protection across the board (e.g. FSA itself has suggested a "three way" split which would not entail the establishment of such across-the-board standards) and, in the absence of more detail, the cost implications of such higher standards are unknown.

It is anticipated that the adoption of a narrow definition could generate significant reclassification of existing wholesale customers and counterparties and would result in a more rigid regulatory approach towards eligibility for inclusion in the inter-professional regime.

Q12./ Yes, because it takes better account of the spread of customers of broad scope firms; provides

Q13. for greater flexibility; and addresses, in a practical way, the fact that there will be many customers falling between the two extremes of "retail" and "professional". At the same time, the FOA supports FSA's recognition that there will be movement between customer categories according to particular markets, products and services and believes that, in general terms, as more people trade more products and seek more services, so more customers will become increasingly better informed and capable of being included in the inter-professional regime, at least in the proposed "intermediate" category (see Q15 and Q16).

For example, if the FSA is successful in its programme for consumer education, it is conceivable that one of the benefits to the industry (who will be paying for and supporting such a programme) will be the possibility of being able to place greater reliance on customer responsibility across a broader range of consumers with commensurately greater financial knowledge and expertise with the consequential reduction (in some respects) of the regulatory burden. However, this will be heavily dependent upon the FSA being prepared to give practical recognition to the outcome of a successful consumer education programme and adopting an approach to classification that accords with its view (para 2.2 of the FSA paper) that, in setting categories, "a full spectrum of expertise" lies between market professionals and retail customers.

While much depends upon the basis of classification and how, particularly, "professional" and "intermediate" categories are defined and the level of regulation and duties that would apply to the "intermediate" category, the FOA believes that flexibility will be best accommodated by the suggested three-way classification of "professional", "intermediate" and "retail" on the basis that (a) it is important that these categories are not restricted as to counterparty types (e.g. individual persons, corporates); (b) it is always open to a particular counterparty to contract in to a higher level of protection in the case of particular products and services or markets and, indeed, to require extra protection in certain areas (e.g. segregation) in respect of dealings on particular markets or in particular products; and (c) "professional" classification is itself subdivided between "market counterparties" and other forms of counterparty (see Q2.).

Q14. Yes. See earlier.

Q15. The FOA agrees that the responsibility for making the classification must be that of the authorised firm but, other than in the case of counterparties eligible for automatic classification (see Q2), the accuracy of that classification will often be dependent upon the information that is provided by the counterparty to the firm. It seems inevitable that such a classification could not be made without the counterparty being involved in the process.

In general, it is anticipated that, in the case of "professionals" proof of counterparty receipt of (a) notice of customer classification; (b) the implications of the relevant classification; and (c) a warning that, in the absence of information to the contrary, that classification will govern the subsequent course of dealings between the parties (and there is a subsequent course of dealings on that basis) should be sufficient to satisfy the regulatory authorities that all has been done that is reasonable and that any ensuing problem is likely to be a consequence of the irresponsibility of the counterparty.

In the case of customers falling into the "intermediate" category, it may be appropriate to require specific oral/written confirmation that such counterparties have received the classification and understand the implications.

Q16. Consideration should be given to the feasibility of “intermediate” customers being provided with a brief summary note of the principle factors that were taken into account by the financial service supplier when categorising the customer. Such information could be included in the notice referred to in Q15. Clearly, there are some categories of information and sources of information which are of a confidential nature. Due regard would have to be given to the fact that, for those reasons, certain classes of information may not be discloseable.

Q17. See Q.15.

Q18. The FOA has reservations about the use of the term “duty of care” which implies a higher and more extensive general duty than an obligation to “know your counterparty”. In essence, the FOA believes that there is an element of the sliding scale about classification so that, for example:

- authorised firms and other large-size corporates, once classified, should have the onus of advising the financial service supplier of any relevant and material changes affecting the original classification (i.e. the burden is on the counterparty and not on the financial service supplier);
- in the case of “intermediate” classifications, it may be appropriate for the firm to send out a reminder notice on, say, an annual basis seeking specific confirmation that the classification is correct - recognising that, presumably, after a given period of time, those in the “intermediate” category may move into the “professional” category.

3. INTER-PROFESSIONAL DEALINGS, MARKET CONFIDENCE AND THE PRINCIPLES

3.1 The FOA supports FSA’s view that “if a firm’s practices are regarded by its peers as unacceptable in relation to established market practices, those participants are likely to terminate dealings with the offending party” (para 3.7 of the FSA paper). There is an overlap between the rest of that paragraph where it expresses concern about inequality amongst professionals and certain aspects of the market abuse provisions (which FSA suggests in para 3.3 lie outside the concerns of this paper). It should be borne in mind that commercial inequality amongst professionals is a natural consequence of competition, so establishment of a “level playing field amongst professionals” where “one party has significantly greater market power than the other” may itself distort competition and market forces.

3.2 While it is recognised that much of the content of the London Code may find itself in the new Handbook, it is important to bear in mind that the dealings of market professionals are covered by contract law, tort, criminal law (including market abuse) and the very general and broad-based FSA Principles. Between them, these provisions address many matters that are already set out in the London Code (e.g. dishonest dealings, fraudulent behaviour, misrepresentation, mistake, insider dealing).

3.3 The FOA supports FSA's intention to operate the "Market Professional" category on an essentially *caveat emptor* basis and with few detailed conduct of business rules. As to the application of the Principles, the FOA recognises that some may be applied to inter-professional business, but would refer to the various concerns set out in its response to FSA's Discussion Paper "Principles for Businesses".

3.4 In general, dealings between "professionals" under the proposed inter-professional regime do not necessitate or require the support of FSA's disciplinary sanctions (other than in the case where there has been what can fairly and properly be regarded as a major regulatory breach that goes directly to the fitness of the authorised institution). While it is recognised that the FSA may wish to have its authority and even, to some extent, some of the fundamental precepts underlying the Code coupled to the threat of disciplinary sanction, the FOA believes strongly that, for the reasons set out above (e.g. threat of loss of business; existing duties and obligations imposed under civil and criminal law and FSA's Principles; and the *caveat emptor* basis of dealings between "professionals"), it is both unnecessary and undesirable to introduce a further tier of sanctions.

Q19. See FOA's response to FSA's consultation on "Principles for Businesses".

Q20. The FOA would prefer to address this matter in a subsequent paper once it has had an opportunity to consult the membership, but, in general, it believes that most of the provisions set out in the London Code and in the Oil Market Code of Conduct are acceptable.

Q21. In developing a code for wholesale business, the FOA recognises that the London Code has, in general terms, worked well for the wholesale financial markets and there is much in the Code that would be relevant to all professional markets. However, in view of the fact that some markets have unique trading practices, FSA may feel that it would be more appropriate to allow the industry to develop a suitable code for such markets on the basis that:

- FSA would be in an authoritative position as to the development and adoption of any such code;
- the Principles will continue to apply to all dealings in such markets;
- FSA has expressed the view that professional markets do not require detailed conduct of business rules or extensive regulatory controls;
- FSA has accepted that it may be appropriate in some cases to "act as catalyst and to develop appropriate standards of market conduct in partnership with the industry".

The FOA believes that it will be appropriate for the FSA to issue guidance giving due recognition to such codes (particularly since FSA will have regulatory oversight and may take action under a

number of its alternative provisions), rather than adopt any such code within its Handbook or through any other form of formal adoption.

Q22. See Q20.

Q23. Yes. The FOA understands that firms do value the existence of the London Code's arbitration procedure and believes it is capable of being extended to other markets - although, many of the products, markets and services covered by the FSA already enjoy arbitration facilities in other fora (e.g. provided by the exchanges) and this may make it unnecessary for FSA to extend the London Code's arbitration procedure to all other markets and market dealings.

Q24- The FOA believes that business carried on in foreign exchange, bullion and wholesale deposits -
Q26 even though they may constitute unregulated business under the Bill - are closely associated with regulated business and they have already been the subject of wholesale regulation under the Grey Paper regime.

The FOA notes FSA's proposal that market participants should produce their own codes of conduct and, while this is an attractive option, it is important that those organisations which produce such a code have, or are able to develop, an appropriate infrastructure necessary for the purposes of supporting and updating such codes and performing any related ancillary activities in relation to them. The FOA questions whether it might not be possible for the Bank of England to continue with its supervisory role in relation to NIPs.