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***Study for an international legislative project on
(contractual) counterparty classification***

(submitted by the Secretariat)

<i>Summary</i>	<i>Consideration of a proposal on (contractual) counterparty classification</i>
<i>Action to be taken</i>	<i>Future work</i>
<i>Mandate</i>	<i>Work Programme</i>
<i>Priority level</i>	<i>To be determined</i>
<i>Related documents</i>	<i>C.D. (88) 7</i>

Introduction

1. The members of the *Advisory Board on capital-markets related work* unanimously ranked highest – together with netting (UNIDROIT 2009 – C.D. (88) 7 Add. 1) – among a list of possible items to be included in the envisaged *legislative guide* a project proposed by the Government of the United Kingdom to facilitate convergence of national investor classification systems standardisation.

2. Recognising the importance of the subject and in order to assist the Governing Council to take a decision on future work in this field, the Secretariat asked Ms Joanna Perkins, Secretary, Financial Markets Law Committee, Bank of England, to submit a study. This study is here attached.

1. STUDY FOR AN INTERNATIONAL LEGISLATIVE PROJECT ON (CONTRACTUAL) COUNTERPARTY CLASSIFICATION

1.1 *Project proposal summary*

The problem: today, a general lack of uniformity in the way in which contractual counterparties (“clients”) are categorised and defined nationally is impeding cross-border commercial activity. The manner of defining client classification concepts such as “consumer”, “retail”, “wholesale” and “professional” differs from country to country with the consequence that there are also differences in the substance of the protections which the clients of businesses receive, the products and services to which they have access and even the enterprises with which they can, in practice, transact. The difficulties and risks posed by the resulting patchwork of contract law and regulatory protections are particularly acute in the arena of financial services, where it is common for the burden of regulation to vary enormously depending on the kind of client – or investor – with which a firm does business.

Adverse effects: national variations in the definition of key client classification concepts such as “consumer” and “business” adversely affect the cross-border conduct of nearly every commercial endeavour owing to the tendency of legal systems to provide separate contract law regimes for consumer contracts at the most fundamental level. However, it affects the international financial markets in particular by imposing increased and unnecessary costs on financial institutions through a complex cross-border patchwork not only of contract law but also of financial regulation.

In the current climate the greatest risk posed by this lack of consistency is almost certainly the increased risk to global financial stability. First, it decreases regulatory efficiency and incentivises market practices aimed at exploiting the inconsistencies, known as regulatory arbitrage. Second, it therefore undermines respect for regulators and regulation. Third, it undermines global market participants’ efforts comprehensively to understand the regulatory regime under which they operate and increases the chance of unfortunate errors and misunderstandings. Fourth, the lack of any shared definitions and standards among national regulators will almost certainly impede any united international attempt satisfactorily to address the causes of the recent global financial crisis by improving the regulation of cross-border financial activity.

Initiatives so far: an enormous amount of work is being done in the private sector to bring the issue, as it affects the financial markets, to the attention of supranational regulators and legislators (including DG Markt, the SEC and IOSCO), but these initiatives, even if successful, will leave serious lacunae. The European Union can only legislate within its own borders and, in fact, has already done so. (MiFID, in the financial services sector, sets out a tripartite classification of investors and, in the wider commercial sphere, unfair contractual terms and practices legislation establishes a definition of a “consumer”.) The SEC and IOSCO are regulatory bodies which are not equipped to consider the private law aspects of counterparty classification, even as it pertains to financial services. (For example, these bodies are not equipped to consider how the retail-wholesale counterparty distinction might operate in the field of private international law. In particular, this question arises when legislators consider whether retail counterparties should universally receive the benefit of the protections of their domestic legal system by means of a choice of law rule to that effect.)

In general contract law a number of supranational initiatives to define consumers and consumer contracts have been successful but little or no truly international work has been done to consider how the counterparty classifications used by the general commercial law might interact with those adopted by national regulatory regimes for financial services.

Proposed solution: the creation of persuasive international guidelines in this area would be instrumental in facilitating both international commerce, particularly in the cross-border financial markets, and sound regulation. Guidelines of this kind should be drawn up under the aegis of a well-respected international organisation with some experience of financial markets law. UNIDROIT is uniquely qualified to undertake the project in this respect.

1.2 *Benefits*

The existing patchwork of national classifications hinders markets by imposing cost inefficiencies and hinders the cross-border provision of products and services. By facilitating legal and regulatory

convergence across borders, it is hoped that international guidelines or standardised definitions could:

- o facilitate international and cross border trade so as to promote and enhance global economic development;
- o develop stable expectations over time and across regions;
- o create legal continuity, both temporal and geographic, so as to be without artificial restrictions;
- o ensure a high degree of congruence between market participants and commercial expectation; and
- o reduce the practical complexities and increase fluidity for firms.

1.3 Burdens

This should not be an unduly expensive project to undertake. What is envisaged is a series of definitions, in the form of short code, according to which counterparties can be classified. A draft instrument should be capable of being produced in less than six months, under the coordination of one part-time secretarial officer. At the same time, work should begin on a series of Explanatory Notes which will provide examples of how the definitions can be used, draw conclusions about best practice in relation to the definitions and, possibly, deal in some way with any need that the markets may have for further (sub)-classifications. (For example, the Notes might offer optional non-fundamental definitions as well.) This work may require greater secretarial support, in which case the Secretary to the Working Group should expect to work full-time on the project.

Additional resources for this project should be sought from parties in the private sector on the grounds that this project will not only contribute to financial and economic stability but also increase commercial efficiency.

In addition to the direct costs of a project, consequent changes could entail short-term, transitional costs for some national authorities and market participants in the Member States who implement the definitions achieved.

It is therefore important that, in order to avoid an unnecessary political or financial burden or the undermining of well-established national regimes, any international legislative project in this field have as its objective supra-national, politically-neutral reform techniques such as the use of broad guidelines, soft law instruments, principles and definitions.

2. DRAFTING TECHNIQUES

2.1 Available techniques

Global standards for commercial and market practice are desirable wherever international agreement is a practical and political possibility and wherever rules may be expected to be relatively stable over time. A particularly strong case for standardisation can be made in relation to counterparty classification and the definition of wholesale and retail business activities because there is a growing international consensus to the effect that distinctions need to be drawn in this field and an expectation that the nature of a retail consumer, say, will not change very much in the years to come.

However, at this stage, international agreement should only be sought on simplified, expansive definitions and general distinctions. Standards of this nature are not only likely to be easier to agree but also to prove more flexible over time and in response to local market idiosyncrasies. For similar reasons, any legislative international project should have as its goal the production of a soft law instrument – perhaps a set of principles, a legislative guide or a model law. Any detail on the implementation of the definitions should be set out in Explanatory Notes or a secondary Guide.

The degree to which such an instrument is a descriptive one, focusing on describing various classes of counterparty, rather than a prescriptive (or normative) one, setting out rules with which local legislators or regulators should comply, will be important in fostering international support. While some degree of prescription is inevitable if the project is to achieve its convergence objective and

also to avoid any tendency towards an overly-detailed documentation of existing national approaches, the effect of this normative burden can be ameliorated by avoiding any rigid prescription of the purposes for which the categories and definitions are to be used locally.

Finally, the legislative project should adopt a functional and/or teleological approach to categorisation. It is important to bear in mind the core outcomes of objectives which the definitions or principles are designed to meet and, in particular, the fact that they may form the basis for regulatory action in a different context. For that reason, the project should avoid, if possible, a legalistic analysis of the extent to which existing rules can be aligned but should look instead to shared goals held in common by different national legal and regulatory regimes to see if those goals can be promoted by standardised definitions.

3. THE PROJECT

3.1 The appropriate forum

An international convergence initiative in the field of counterparty classification could be well accommodated by UNIDROIT, a widely-respected international organisation which has as its objective the modernisation and harmonisation of private law. In particular:

- UNIDROIT already has experience of projects in the field of financial markets law, having recently brought its project on intermediated securities close to a successful conclusion.
- projects are introduced at UNIDROIT through the medium of expert analysis and project preparation which is appropriate for a technical and market-sensitive project of this kind.
- the organisation's independent status facilitates the use of technical working methods and, to a degree, insulates it from the international politics that may bedevil other global legislative initiatives.

3.2 Possible project outcomes: the instruments

Two draft instruments are attached hereto for consideration. The first is in a "Definitions" format and the second, in a "Principles" format (See Appendix A and B). Both drafts seek to incorporate standards which clearly demarcate categories of counterparties in accordance with their relative sophistication. The first draft (at Appendix A) is closely focused on the need for a unified investor classification regime in the financial markets, the second draft is less closely focused and encompasses counterparty classification in the wider commercial sphere.

It has already been suggested above that any instrument designed to operate at an international level must have the flexibility to respond, upon application, to the local market needs. For this reason the instrument based on the "Principles" legislative model is deliberately vague as to the regulatory or legal context in which the principles are to be used by any relevant national authority ("RNA").

It may be that neither instrument would require very significant legal or regulatory changes in sophisticated economies. However, the promulgation of these definitions and compliance with them could carry enormous benefits as a template for developing legislation and regulation in the emerging markets.

3.3 Recent UK/EU implementation of MiFID

Concerns may arise among Member States that an international instrument could have the potential to supersede existing local investor classification schemes and disrupt existing regulatory frameworks. This concern is likely to be particularly acute in the context of the recent UK/EU implementation MiFID which has imposed a heavy cost burden on national authorities and private sector institutions alike.

It should be stressed that, for the reasons given above, the proposed project is not intended to undermine or significantly to disrupt the local investor classification practices with which market participants have struggled to familiarise themselves.

However, in the area of the “passporting” of firms, MiFID has yet to deliver the full range of cost benefits which were initially anticipated by its proponents. The international standardisation of broad categories of counterparty, or investor, could enhance these intended benefits by extending the reach of the *basic* client classification regime recognised under MiFID to third countries while strongly encouraging exemptive relief or mutual recognition on the basis of the definitions adopted.

APPENDIX A**DRAFT UNIDROIT DEFINITIONS AND MODEL RULES****DRAFT UNIDROIT COMMON FRAME OF REFERENCE FOR (CONTRACTUAL)
COUNTERPARTY CLASSIFICATION –DEFINITIONS AND MODEL RULES**

THIS instrument is the result of three years' collaboration of jurists and financial markets and regulatory experts representing the Member States of UNIDROIT. It began in 2009 and was continued in a series of 4 drafting sessions. Significant contributions to the process of drafting were made by consultative experts and observer delegations from [IOSCO] and [CESR].

DEFINITIONS**1. Parties**

1.1 A *financial markets participant* is an economically-active undertaking whose business is the provision of financial services and/or financial products and which is subject to legal and regulatory control.

1.2 An *investor* is an organization, corporation, individual, or other entity that enters into a contractual agreement with a financial markets participant for the purchase of financial services and/or financial products.

1.3 An *issuer* is an economically-active undertaking which issues financial instruments in the course of its trade or business where those financial instruments are [intended to be] acquired by one or more investor who will thereby assume some risk of loss.

1.4 A *financial intermediary* is a financial markets participant which enters into contracts with both an issuer and an investor in order to act as intermediary in the supply of financial instruments by the issuer to the investor.

2. Activities

2.1 A *transaction* is a contract for the supply of financial products and/or services between a financial markets participant and an investor.

2.1.1 *Wholesale transaction* means a contract for the supply of products and/or services by a financial markets participant directly to a person other than the end-user, i.e. to a commercial intermediary.

2.1.2 *Retail transaction* means a contract for the supply of products and/or services by a financial markets participant directly to the end-user investor.

2.2 An *issue* is a single, collectively identifiable issue of securities or other financial instruments.

3. Investor classification

3.1 A *professional investor* is a legal or natural person who enters into a transaction in the course of his business or profession, where the transaction represents a core activity in that business or profession.

3.2 A *non-professional investor* is any other investor.

3.2.1 A qualified investor is a non-professional investor who has been identified either a) by a relevant regulator or b) by means set out in legislation or regulation applying to the financial markets participant in its dealings with the investor, as appropriately requiring a lower level of regulatory and/or legal protection than other non-professional investors.

3.2.2 A non-qualified investor is any other non-professional investor.

MODEL LEGISLATIVE AND REGULATORY GUIDE

The law or regulation should provide ...

4. Offering restrictions

4.1 exemptions from prospectus registrations requirements for offers of securities made to professional and/or qualified investors.

4.2 exemptions from registration requirements for offers for sale of units in collective investment undertakings to professional and/or qualified investors.

4.3 that where a securities issue is offered for sale exclusively to professional and/or qualified investors, the issuer or financial intermediary should not have to notify or file documents with the regulator.

4.4 exemptions for communications directed exclusively at professional and/or qualified investors from any marketing restrictions pertaining to an offer of securities.

5. Conduct of business rules

5.1 exemptions in relation to transactions with professional and/or qualified investors from restrictions imposed by conduct of business rules.

6. Foreign firms

6.1 partial exemptions from the range of licensing and authorisation requirements for foreign financial markets participants conducting business in the jurisdiction, in cases where the business in question consists exclusively of transactions with professional and/or qualified investors or wholesale transactions.

APPENDIX

[A comparison chart of sample investor classification rules and tests from Member States could be inserted here.]

APPENDIX B**DRAFT UNIDROIT PRINCIPLES OF (CONTRACTUAL) COUNTERPARTY CLASSIFICATION****DRAFT UNIDROIT PRINCIPLES OF COUNTERPARTY CLASSIFICATION**

WHEREAS:

- the facilitation of international and cross-border trade in products and services will promote and enhance global economic development;
- if markets are to grow and flourish, national law and regulation must permit and encourage market participants to develop stable expectations over time and across regions;
- a stable planning environment is conducive to investment and, therefore, market growth;
- in order to create such an environment, a degree of legal continuity must be present in the legal system or systems within which the market participants operate. This continuity must be both temporal and geographic if investment and growth are not to be artificially restricted;
- the geographical continuity of law and regulation can be improved by both the efficient operation of private international law and by initiatives to bring about legal and regulatory convergence across borders;
- a global environment in which there is a high degree of congruence between participants' commercial expectations, formed in their domestic environment, and the overseas legal or regulatory frameworks within which they operate will better preserve property and contractual rights and protect investment, thus encouraging productive and efficient capital allocation;
- there is the lack of uniformity, from country to country, between categorisations for wholesale, intermediate and retail contractual counterparties;
- the range of classifications currently in existence is thought to create market inefficiencies; adversely to affect cross-border commerce; and to result in unnecessary costs for enterprises;
- the wide divergence in classifications creates uncertainty, with the result that some consumers do not receive the ideal level of protection, whilst some businesses may become overburdened with too much regulation.
- it is widely recognised that the need for some form of international investor or counterparty classification is particularly acute in the field of financial markets law and regulation; and
- it is commonly held that international guidelines in this area would be instrumental in facilitating trade in financial markets and its sound regulation.

The Member States have agreed upon the following principles to promote international convergence in the sphere of investor classification:

Scope and implementation

These principles incorporate standards for circumscribing categories of counterparty according to levels of market sophistication and qualification in the context of market-facing activities engaged in by an undertaking ("the undertaking") which is subject to legal and regulatory control. These principles may be appropriate for a variety of regulatory and legal purposes, to be settled upon at the discretion of relevant national authority ("RNA").

Commentary

The preamble is deliberately vague as to the regulatory and legal context in which the principles are to be used by the RNA. Deciding whether it is desirable or necessary to distinguish, in respect of any given commercial activity, between the levels of sophistication manifested by the counterparties with which an undertaking transacts involves careful reflection on the domestic commercial landscape. Possible areas for consideration by RNAs for the implementation of these principles are: prospectus and disclosure requirements, marketing restrictions, conduct of business rules, and licensing requirements. More broadly, RNAs may wish to consider whether the principles have implications for commercial/contract law on unfair terms, and jurisdictional or choice of law rules offering consumers, including investors in financial products, the protection of their own law or forum.

Principle 1

The RNA, having adopted these principles of counterparty classification for any regulatory or legal purpose, shall use its best efforts to ensure that the level of protection afforded to counterparties which have been identified by the principles as having a greater degree of sophistication or qualification shall be no greater than the level of protection afforded to less-sophisticated or less-qualified counterparties.

Commentary

This principle is critical to the core objective of the principles: the purpose of this instrument is to facilitate a degree of global convergence on broad categories of counterparty in the field of financial services law and regulation. It is essential to this objective that national authorities adopting this schema should do so in a mutually convergent way, namely: levels of regulatory and legal control imposed on undertaking should lessen in respect of its activities with sophisticated or qualified counterparties.

Principle 2

The RNA shall draw a distinction between

- 1. wholesale; and*
- 2. retail*

activities conducted by the undertaking with one or more counterparties.

Commentary

Wholesale here means the supply of products and services directly to a person other than the end-user, i.e. to a commercial intermediary.

Retail here means the supply of products and services directly to the end-user, whether to a business or a consumer, whether to an institution or a natural person.

Where this principle is adopted, wholesale activities are those with qualified counterparties and retail activities are activities with counterparties who are prima facie less qualified.

Principle 3

In respect of retail activities conducted by the undertaking, the RNA shall draw a further distinction in relation to counterparties as follows:

EITHER between-

- 1. a natural person acting within the course of his business or profession or any legal person; and*
- 2. a natural person acting outside the course of his business or profession (“a non professional (Type A)”);*

OR between-

1. *a natural or legal person acting within the course of his business or profession; and*
2. *a natural or legal person acting outside the course of his business or profession (“a non professional (Type B)”);*

OR between-

1. *a natural or legal person acting within the course of his business or profession for whom the transaction represents a core business or professional activity; and*
2. *a natural or legal person who is either a) acting outside the course of his business or profession; or b) for whom the transaction represents a non-core activity which is incidental to the ordinary course of business (“a non professional (Type C)”);*

Commentary

The functional distinction between business (or professional) and consumer (or non-professional) counterparties is a standard which has been widely accepted by national legal and regulatory regimes but a variety of different definitions are used. Implementation of the standard involves elements of judgment and experience of the domestic market which the national authority can bring to bear and a degree of discretion should, therefore, be reserved to that authority. However, a finite number of alternatives have been proposed in the interests of clarity, predictability and uniformity.

Where this principle is adopted, non-professionals identified by the alternative which is being implemented (whether Type A, B or C) are prima facie less qualified than other counterparties.

Principle 4

4.1 The RNA shall establish guidelines for identifying those non-professional counterparties (whether Type A, B, or C) who are likely to require a lower level of legal or regulatory protection (“certified” or “eligible” counterparties).

4.2 Those guidelines may take into account any or all of the following non-exhaustive criteria for identifying appropriate counterparties:

- a) net or gross worth;*
- b) net or gross income;*
- c) expertise;*
- d) length of experience;*
- e) third-party evaluation;*
- f) willingness to forgo levels of protection which are normally considered appropriate for non-professionals.*

4.3 The RNA may establish guidelines for undertakings identifying certified or eligible counterparties which refer directly, without more, to the relevant criteria or which refer, alternatively to some established process (e.g. certification) which is conducted on the basis of the relevant criteria.

4.4 In respect of counterparties who are non-professionals (whether Type A, B, or C), the RNA shall draw a distinction between activities conducted by the undertaking with:

1. *counterparties who are certified or eligible; and*
2. *all other counterparties.*

Commentary

Where this principle is adopted, it is appropriate prima facie for the RNA to afford a lower level of legal or regulatory protection to eligible or certified non-professionals than to other non-professionals.