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Tom Loonen, Randy Pattiselanno,

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Tom Loonen
Postgraduate Investment Management, School of Business and Economics, VU Business School, Amsterdam, The Netherlands, and
Randy Pattiselanno
University of Amsterdam Academy for Banking and Insurance, Amsterdam, The Netherlands

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Abstract

Purpose – This paper aims to identify the duty of care that applies to 'professionally classified clients' based on the recently implemented Markets in Financial Instruments Directive II (MiFID II) as well as the previous Markets in Financial Instruments Directive I (MiFID I). The authors place critical notes on the effectiveness of some MiFID provisions.

Design/methodology/approach – The authors have reviewed the Delegated Acts of MiFID I and II, as well as Q&A's of the European Regulator, ESMA and jurisprudence. The authors aim to add value by facilitating a discussion on the effectiveness of applicable MiFID provisions.

Findings – This review of the legal provisions provides researchers and practitioners in the investment sectors with a clear overview of the legal provisions detailing how these provisions should be met and how improvements to the provisions can be achieved.

Practical implications – This paper specifies what the provisions for professional classified clients are and facilitates a discussion on the effectiveness of these provisions.

Originality/value – Addressing the legal provisions which are applicable to 'professional classified clients' that derive from MiFID I and II and includes a critical analysis which offers an original perspective.

Keywords Effectiveness, Duty of care, Professional, MiFID II, Banking regulation, Investor

Paper type Technical paper

Introduction

The implementation of both European investment directive Markets in the Financial Instruments Directive I and II (MiFID) has affected a large number of investment services. To strengthen investor confidence and to raise investor protection, extensive transaction reporting, product approval provisions and investor protection provisions[1] are been implemented. With regard to investor protection, legislation is particularly focused on 'retail clients' (also referred to as 'non professional clients'), as the duty of care required for these clients is considered the most extensive. Although MiFID II does not contain a large number of relevant new investor protection obligations for professional classified clients, under MiFID I, the obligations remain comprehensive and attempt to improve the position of the professional investor.

What are these provisions under MiFID and are these provisions effective? These two questions shall be answered in this paper. In the first section, we shall provide a definition of the professional client and the client classification options within MiFID. The second section

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aims to provide a clear overview of the MiFID provisions with regard to professional clients[2]. We shall conclude by commenting on these MiFID provisions. These comments are made from both an academic and empirical perspective to stimulate a discussion on the effectiveness of these provisions. It is hoped that this discussion will contribute to the evaluation of the provisions by the EU Council and EU Parliament in 2021.

Definition and classification of 'professional client': Dutch legal history contains several definitions of 'professional client'. For example, a distinction in the Dutch Financial Supervision Act is made between 'professional client' and 'professional market party'. The latter may be a qualified investor, a subsidiary of a qualified investor that is involved in the supervision on a consolidated basis on the qualified investor or any other person or company designated as a professional market party.

Under MiFID, the classification of clients in either retail clients, professional clients or eligible counterparties is mandatory. It is compulsory to inform the client about its classification, which should take place before financial services being provided. The way in which the investment firm classifies a client ultimately determines the level of client protection that the client enjoys and, thus, what provisions under MiFID apply to the investment firm, where the first category enjoys the most client protection and the latter, the least protection.

There are two types of professional classification. One is considered to be a 'professional client per se' according to the MiFID directive[3], if the following conditions are met:

(1) entities which are required to be authorized or regulated to operate in the financial markets such as credit institutions, investment firms, insurance companies, collective investment schemes and pension funds;
(2) large undertakings meeting two of the following size criteria (on a company basis):
   - a balance sheet total of $\geq$ €20,000,000;
   - a net turnover of $\geq$ €40,000,000; and
   - possessing own funds of $\geq$ €2,000,000.
(3) national and regional governments, including public bodies that manage public debt at national or regional level, central banks, international and supranational institutions such as the World Bank, the IMF and the ECB; and
(4) other institutional clients whose main activity is to invest in financial instruments, including entities dedicated to the securitization of assets or other financing transactions.

Under certain conditions, it is permitted to classify retail clients as professional (so-called 'opt-up professionals'), in which case a qualitative and quantitative assessment should be done. During the quantitative assessment, a minimum of two of the following criteria[4] must be met:

- The client has carried out transactions of 'significant' size, on the relevant market at an average frequency of 10 transactions per quarter over the previous four quarters.
- The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000.
- The client works or has worked in the financial sector for at least one year in a professional position, which requires (or required) knowledge of the transactions or services envisaged.

If this quantitative assessment is passed, then the expertise, experience and knowledge of the client must be assessed from a qualitative perspective. The outcome of this assessment should provide reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making sound investment decisions and understanding the risks involved.

It is possible for the professional client to request to be treated as a retail client, either in general or per transaction or service. It is at the discretion of the investment firm to agree to this request. If the investment firm agrees, then the client can rely on the higher level of investor protection that applies to retail clients. If the client is classified as a professional client, then it is his responsibility to request a higher level of protection if he does not consider himself able to adequately assess or manage the risks involved. Professional clients are also responsible for informing the investment firm of any change in circumstances which could affect their categorization. However, should the investment firm itself become aware that the client no longer fulfils the initial ‘professional classification conditions’, appropriate action must be taken. An example of this is when the investment firm becomes aware or should have known that the size of its client’s investment portfolio has fallen below the €500,000 threshold which was one of the criteria based on which the client could opt up for a professional client status.

When it comes to client classification, MiFID II brings a substantial change to one component: the classification of local authorities such as provinces and municipalities, which may have ‘opted up’ to a professional client status.

The ‘professionals’ mentioned below have suffered substantial losses. In the light of these types of occurrences, it was decided under MiFID II to allow Member States to adopt specific criteria for the assessment of the expertise and knowledge of municipalities and local public authorities requesting to be treated as professional clients[5].

> In Italy between 2001 and 2008, local authorities entered into approximately 1,000 interest rate swaps with a value of €35bn representing the equivalent of about one third of all debts of Italian regions, provinces and local authorities. The Bank of Italy calculated that the losses had risen to approximately €1bn. For example, the City of Milan has litigated against four banks that stand trial for aggravated fraud over an interest swap on a €1.68bn bond issue. The swap caused substantial losses, with the banks being accused of raising €101mn in hidden fees.

> In December 1994, Orange County, a prosperous district in California, was declared bankrupt. This was the result of substantial losses of approximately US$1.6bn incurred by the investment pools intended to manage the Orange County cash flows and those of 241 associated local government entities. The investment pool was managed by the treasurer, Robert Citron, who controlled the investment pool. He had invested the pooled funds in a leveraged portfolio of mainly interest-linked securities. His investment strategy depended on low interest rates. However, as from February 1994, the Federal Reserve Bank began to raise US interest rates, causing many securities in Orange County’s investment pool to fall in value which resulted ultimately in the aforementioned losses. Citron had been a treasurer for 22 years and, because of his long track record, was considered to be a professional with a large amount of knowledge and experience.

KYC provisions on professional clients

When it comes to Know Your Customer (KYC) provisions, the investment firm is faced with a multitude of provisions that must be complied with. For example, intended transactions by a retail client must be tested for appropriateness and/or suitability by the investment firm. These tests are less significant and impactful for professional clients mainly because of the assumption that there is an appropriate level of knowledge and experience present with professional clients.

Under MiFID, a number of presumptions are permitted with regard to a professional client. Where an investment firm, as part of the appropriateness or suitability test, carefully assesses and records the investment experience and knowledge of a retail client; this exercise is not mandatory for professional clients. With regard to the professional classified clients, it may be assumed that they have the necessary experience and knowledge to understand the risks involved of particular investment services or transactions or types of transaction or product, for which the client is classified as a professional client[6]. Furthermore, the investment firm may assume that the *per se* professional client is financially able to bear any related investment risks consistent with its investment objectives. As a result, the investment firm is generally not required to obtain financial information on the professional client. However, according to ESMA, this only seems to apply to investment advice services. In some cases where the client's investment objectives demand it, for example, if the client requires an investment product for hedging purposes, then information of the financial position will need to be obtained[7]. The reason for such is to be able to propose an effective hedging instrument. When it comes to portfolio management, it seems that an inventory will have to be done to assess the ability to bear losses related to investment risks[8]. This includes, if and when applicable, obtaining information on the source and extent of regular income, assets (including liquid assets), investments and real estate and regular financial commitments[9].

> In The Netherlands, as a result of inter alia the 'Vestia case', housing corporations may by law only enter into financial derivatives if the corporation is classified as a retail client. Vestia is a housing corporation that entered into interest rate derivatives with a number of banks. As a result of changing market conditions the market value of its derivatives portfolio amounted to approximately €3bn in negative value which almost resulted in the bankruptcy of Vestia at the end of 2011 before the Dutch State intervention. The losses actually suffered by Vestia amounted to approximately €2bn. Given the size of the housing corporation, Vestia could be classified as a per se professional client under MiFID. In 2011, it appeared that up to 87 per cent of all Dutch housing corporations could indeed be classified as per se professional client under MiFID. The consequence thereof was that housing corporations did not benefit from the investor protection rules afforded under MiFID for retail clients. A number of banks did not consider Vestia a client to which it provided an investment service but considered Vestia a counterparty to the interest rate swap contract. Accordingly, as one the measures to reduce unnecessary losses, the Minister of Internal Affairs stipulated that government regulated housing corporations may only enter into certain derivatives transactions for hedging purposes if the investment firm classifies the housing corporation as a retail client.

Furthermore, the investment objectives of the professional client have to be obtained and recorded when providing investment advice or portfolio management. The information regarding the investment objectives of the professional client must include, if and when applicable, the investment horizon, the preferences regarding risk-taking, the risk profile and the purpose of the investment[10].

Information obligations towards professional clients

As described above, not only does MiFID require an investment firm to classify a client, but also requires that the client should be informed about his or her (re)classification in writing.

> Case law in The Netherlands has taught that not informing the client of his or her (re) classification may not only result in a breach of a regulatory requirement but it may also have civil law consequences. In an extra-judicial court hearing, it was decided that although the financial institution (in casu 'Hanzevast') may rightfully have classified the client as a professional client, it had failed to inform the client of this. As a consequence of this failure, the

client enjoyed the protection of a retail client. This resulted in the verdict that the client was able to claim part of the damages suffered.

In general, under MiFID, the core information obligations imposed upon investment firms are similar for both professional and retail clients. All information is subject to the main principle, meaning that any and all information provided to clients should be "fair, clear and not misleading"[11]. This makes sense, as there should be no reason why application of this principle should vary depending on the type of clients.

However, MiFID acknowledges that the information provided to a client should take into account the status of such client as either a retail, professional or eligible counterparty. As a result, less stringent information obligations may apply to professional clients[12].

The main rule is that investment firms must provide the (compulsory) pre-contractual information in good time[13]. This relates to, for example, contact details of the investment firm, the specific investment services and ancillary services the investment firm provides, its conflict of interest policy and specific information related to portfolio management if and when provided by the investment firm.

Nonetheless, the Dutch Supreme Court in the 'World Online' prospectus liability case seemed, to some extent, to indicate otherwise although more in the context of whether or not it is likely whether a professional client may base its investment decision on information which may potentially be misleading in comparison to the retail client. In this case, investors claimed damages from World Online and a syndicate of banks because of incorrect and potentially misleading information contained in the prospectus. The Supreme Court considered that in the case of a professional client, rather than a retail client, it could be argued that despite the presence of misleading information in the prospectus, the investment decision of a professional client is likely not to be influenced by that misleading information.

When providing pre-contractual information, one must ensure that the manner of communication is in line with the investment firm's general way of communication. In addition to compulsory pre-contractual information, investment firms also provide non-mandatory pre-contractual information to prospective clients. Such information, normally labelled as 'marketing', is, under MiFID, subject to certain conditions. For example, the marketing information should always give a fair and prominent indication of any relevant risks simultaneously with information concerning the potential benefits of an investment service or financial instrument[14]. Furthermore, the marketing information should use a font size in the indication of relevant risks section that is at least equal to the predominant font size used throughout the information provided, as well as a layout ensuring the prominence of such indication[15]. This requirement basically prohibits presenting risks in a font smaller than the predominant size used in the marketing material text. In addition, all information and marketing materials must be consistently presented in the same language throughout, unless the client has agreed to receive information in more than one language[16].

MIFID does not appear to differentiate between marketing information provided to retail clients or professional clients. However, in its advice to the Commission, ESMA made an explicit distinction between information provided to retail clients or professional clients. ESMA indicated that "Information addressed to or likely to be received by professional clients or potential professional clients:

- shall not reference any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks;

- shall not disguise, diminish or obscure important items, statements or warnings; and
- shall be accurate and up-to-date, relevant to the method of communication used"[17].

Unlike for retail clients, ESMA was not of the opinion that requirements as to the font size in the indication of relevant risks and to the consistent use of the same language throughout all forms of information and marketing materials should be applicable to professional clients. The question arises whether one can assume that this approach by ESMA may still be interpreted as an elaboration of the principle that it is appropriate to establish less stringent specific information requirements with respect to professional clients than to retail clients. In practice, it is arguable that this is the case.

Information on financial instruments

Pursuant to MiFID, investment firms are obliged to provide information on financial instruments. Such information relates particularly to the nature, characteristics, functioning, performance of and risks associated with financial instruments. The description of risks may include *inter alia* risks related to leverage and its effects, the insolvency of the issuer or the volatility of the price of such instruments and illiquidity risks. Information should be clear enough for the retail or professional client to base their investment decision upon it. The level of detail of the information to be provided on such financial instrument may, however, vary depending on whether this concerns a retail client or a professional client[18].

First, one assumes that the level of detail of the wording used, particularly the language and complexity of investment terminology, may be different for retail clients compared to professional clients. An example where ESMA expresses a difference between product information which needs to be provided to retail clients vis à vis professional clients are financial products that fall under the PRIIPs-regulation[19]. PRIIPs relates to packaged retail investment and insurance products, such as complex structured products and derivatives. Given the complexity of such products, the PRIIPs regulation obliges those who produce or sell investment products to provide (only) retail clients with key information documents (KIDs) on such products. A KID on a PRIIPs product is a document with a maximum of three pages and provides clear information on a particular investment product. Second, there is a presumption that professional clients, as opposed to retail clients, are more capable of understanding the information provided. Professional clients are in addition also in a better position to ask specific questions regarding such information or to obtain advice from other (external) parties.

Information on bundled products

MiFID II requires that when an investment service is offered together with another service or product as part of a package or as a condition for the same agreement or package, the investment firm shall inform the client whether it is possible to buy the different components separately and shall provide for a separate evidence of the costs and charges of each component[20]. This is referred to as a 'bundled product'. Where such bundled product is offered to a retail client, MiFID II requires that where the risks resulting from such an agreement or package are likely to be different from the risks associated with the components taken separately, the investment firm needs to provide an adequate description of the different components of the agreement or package and the way which interaction modifies the risks. This additional information obligation does not apply to professional clients presumably in the understanding that professional clients are able to appreciate the interaction of the different components in the bundle, including the relevant risks involved.

Examples of bundled products are security-based credits or a credit facility combined with an interest rate swap to hedge interest rate risks.

Information on costs and associated charges

Under MiFID II, the investment firm's obligations to disclose information on all costs and charges to clients are increased. Such increased costs transparency relates to *inter alia* the obligation imposed upon the investment firm to provide an aggregated overview of all of the expected costs to the client before providing any services ('ex-ante costs disclosure'). Such aggregated costs disclosure relates to[21]:

- the costs of the services, both investment services and ancillary services; and
- the costs of the financial instruments, for example ongoing costs and charges of investment funds.

Clients with whom the investment firm has an ongoing relationship must be provided at least once a year with information of the total costs and charges actually incurred for both the services and the financial instruments ('ex-post disclosure').

Such transparency obligations are also extended to investment services provided to professional clients and eligible counterparties. Nonetheless, under MiFID, investment firms are permitted, when providing investment services to professional clients, to agree with these clients to limit the detailed requirements set out in the regulation. In that respect, information on costs and charges to professional clients may be different compared to those to retail clients. There are, however, situations where an investment firm cannot agree otherwise with the client. This is the case:

- when an investment firm renders investment advice or portfolio management services; or
- where irrespective of the investment service provided, the financial instruments concerned embeds a derivative[22].

In such cases, therefore, the level of detail of the information obligations are identical to both retail and professional clients.

As well as the investment firms' obligations to disclose information on all costs and charges to clients, the investment firm is obliged to provide an illustration showing the cumulative effect of costs on the investment return[23]. Again, investment firms may agree, upon the request of the professional clients, not to provide such illustration. The same applies for the obligation to provide information, where relevant, on the currency involved and the applicable conversion rates and costs where any part of the total costs and charges is expressed in foreign currency.

Information on best execution policy

Investment firms are obliged to take adequate measures to obtain the best possible result when executing the client's orders. This obligation is also referred to as the 'best-execution'-obligation. In the effort to obtain the best possible result for clients, investment firms need to take into account various factors such as security price, costs, speed, likelihood of execution and settlement, size, nature or any other aspect relevant to the execution of the order[24]. MiFID provides that one of the factors that should be taken into account are the characteristics of the client including the categorization of the client as retail or professional. Furthermore, MiFID provides that when an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to execution. For professional clients, other factors, that is, other than the total consideration, may be equally or even more relevant for obtaining the best possible result[25].

The measures to obtain the best possible result when executing the client's orders are normally also reflected in the information on the order execution policy of the investment firm. Under MiFID, there are several differences between providing information on the execution policy to retail clients as opposed to professional clients. First, where an investment firm executes orders for retail clients, it is obliged to provide those clients with a summary of the relevant policy, focused primarily on the total costs they incur[26]. Second, investment firms are required as an ongoing obligation to summarize and to publish on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where client orders have been executed in the preceding year and information on the quality of execution obtained. MiFID II distinguishes, in terms of the format that needs to be published, between such information to be provided to retail clients and to professional clients[27].

Inducements regime

The main principle under MiFID is that investment firms when they are providing investment services and/or ancillary services to its clients must act "honestly, fairly and professionally in accordance with the best interests of their clients"[28]. A subset of this principle relates to the MiFID II inducements regime. The inducements regime under MiFID II stipulates that investment firms paying (or being paid) any fee or commission or providing or being provided with any non-monetary benefit in connection with the provision of their investment services or ancillary services to the client should ensure that such payment or benefit:

- is designed to enhance the quality of the relevant service to the client; and
- does not impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the best interests of its clients[29].

MiFID II provides that in certain circumstances, the investment firm is prohibited from receiving such third-party fees, unless it transfers such fee or commission in full to its client[30]. This is the case with regard to the portfolio management and independent investment advice services.

With regard to inducements, MiFID II does not differentiate between the types of client. However, in some member states within the EU, this distinction has been made depending on the type of clients. This distinction was made possible because MiFID created 'a member state option' facilitating a deviation from the main rule laid down in MiFID. In The Netherlands, for example, the MiFID regime is applicable where the investment firm provides investment services to professional clients. However, The Netherlands have implemented a full inducements ban when investment services are provided to retail clients, which ban goes beyond the restrictions of MiFID I and II. More in particular, where the investment firm provides investment services to retail clients, including independent investment advice or execution only services, the receipt of third-party fees by such investment firm is prohibited, even if the investment firm is willing to transfer such inducements in full to its clients.

Reporting of losses

Under MiFID II, it is mandatory for the investment firm to report, in relation to managed portfolios, losses suffered[31]. This means in practice that when the overall value of a portfolio declines with 10 per cent (or more) in the reporting period, it must be reported at the latest at the end of the business day in which the threshold is exceeded. This obligation also applies to all clients of the investment firm. However, there is an additional obligation to report a 10 per cent decrease in leveraged financial instruments or contingent liability transactions to retail clients which is not mandatory for professional clients.

Product governance

Under MiFID II, product governance requirements have been introduced to ensure that investment firms which manufacture and/or distribute investment products or financial instruments act in the clients' best interests during the life-cycle of the financial products or investment services. MiFID II creates separate obligations for investment firms that manufacture financial instruments and investment firms that distribute financial instruments.

An investment firm qualifies as a manufacturer if the activity involves the creation, development, issuance or design of that product. A distributing investment firm refers to a firm that offers, recommends or sells an investment product and service to a client.

Furthermore, investment firms, both manufacturers and distributors, need to have a product governance arrangement and product review process in place. One of the most important product governance requirements under MiFID II is that the investment firm should assess the target market of investment products distributed to its client. The investment firm, therefore, needs to ensure that its distribution strategy is in line with the target market of investment products distributed via the relevant investment services the firm offers. Product governance requirements under MiFID II apply irrespective of the nature of the client. However, the outcome of the product governance process may vary depending on whether an investment firm manufactures and/or distributes investment products to professional clients or to retail clients. This results from the following factors: First, some investment services or transactions are not appropriate for retail clients. MIFID II provides that certain arrangements may not be offered to retail clients at all. This concerns title transfer financial collateral arrangements (TTCA's) for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients. In addition, and more importantly, a number of investment products are eligible for professional clients only. ESMA indicated in its guidelines that some products, in particular investment products that have complex risk profiles, for example contingent convertible bonds, will have a more narrowly defined target market[32]. Such products may only be offered to *per se* professional or elective professional clients who are likely to understand the complexities associated with these products. In other words, this means that a wide variety of products are, from a target market perspective, only available to professional clients. Second, where an investment firm offers services to professional clients, as end-clients, several requirements which need to be taken into account by such investment firm will be significantly different in comparison to product governance arrangements related to retail clients. In its guidelines, ESMA has acknowledged that for investment products designed for professional clients as an end client, the overall assessment of the target market may be less comprehensive compared to the assessment for the retail clients as end-client.

Where an investment firm needs to assess the target market, either in capacity of manufacturer or distributor, the firm must use the categories defined by ESMA in its guidelines[33]. The guidelines include factors such as:

- the type of (potential) clients to whom the product is targeted;
- the investment knowledge and experience present;

- the financial situation of the (potential) client with a focus on the ability to bear losses;
- the risk tolerance and compatibility of the risk/reward profile of the product with the target market; and
- the (potential) client's objectives and requirements.

The element 'the type of clients' to whom the product is targeted refers to the MiFID client categorization framework, that is, retail clients, professional clients and eligible counterparties. ESMA acknowledged that MiFID II allows that certain assumptions may be made about a client's knowledge and experience with respect to understanding investment risks. However, it should be noted that there is a difference between professional clients *per se* and opted up professional clients. It should not be presumed that clients belonging to the latter category possess the knowledge and experience of professional clients *per se*.

Critical analysis of the effectiveness of MiFID provisions

A critical view on a number of MiFID provisions is contained below, where we have reviewed and commented on a number of eye-catching provisions for professional clients.

Paradigm on knowledge and experience

First, the material differences between a professional and retail client shall be focused on. This is important, as the spirit of the directive is based on the presumption that the representative(s) of a professional client has sufficient relevant investment knowledge and experience. What is legally qualified as 'sufficient knowledge and experience' does not have to be so from a financial-economic perspective. In particular, dealing with risks, where the risk appetite is of great importance, can be different and lead to other (financial) outcomes. In economic literature, various studies show that the difference between a professional client and a retail client can be significant. Venezia *et al.* (2011) conclude that the difference between professional and retail clients is mainly because retail clients take their investment decisions independently and do not leave this to professional managers. Maybe more distinctively, retail investors suffer, to varying degrees, from behavioral biases like loss aversion, disposition effect, herd behavior, ostrich effect and hindsight bias (Ofir, and Wiener, 2016). The tendency of 'amateur' investors to exhibit 'herd behavior' (investors imitate the behavior of the other investor and then (partially) ignore their own information and beliefs) was confirmed previously by Venezia *et al.* (2011). The researchers attribute this behavior to a lack of financial and economic training. This behavior causes systematic and economically large losses, whereas professional investors show outperformance (Barber, 2009). This difference is (again) related to poor investment training which results in limited diversification of portfolios and poor trading decisions.

The difference in behavior is also reported by Shapira and Venezia (2007). They illustrate with empirical research that professional investors show more sophisticated behavior than individual investors. For example, when it comes to distinctive differences in behavior, earlier research has shown that institutional investors invest less at home (Grinblatt, and Keloharju, 2001) and are better at taking profits (Shapira, and Venezia, 2001). Menkhoff *et al.* (2009) studied two groups of professional investors and compared them with laymen by means of a survey. They found that institutional investors behave in a more sophisticated manner than laymen.

The financial crisis has shown, however, that there are limitations to the ability of professional clients to assess the risk associated with their investments. By including some examples (City of Milan, Orange County and Vestia), we have illustrated that knowledge and experience were assumed to be present with professional clients but were not found to be material in any way. It is therefore justified to question whether all professional investors have sufficient, deep-rooted knowledge of markets, characteristics and risks of portfolio theory and asset allocation to be able to take independent investment decisions. An investment firm must monitor the financial goals and risk appetite/tolerance of the professional client but aspects as to the ability to bear losses and knowledge and/or experience are not considered. This is remarkable because the degree of knowledge and experience can have a direct impact on risk tolerance. In addition, monitoring risk appetite does not make much sense if the knowledge and experience of the professional investor is not taken into account. Usually the impact of investment knowledge/experience in an investment advice will be marginal, but if there are two different but similar investment strategies or different risk and/or complexity is being considered, then investment knowledge and/or experience can have a major impact on the final choice. In conclusion, effective measures should be sought in risk controls and strong oversight to prevent an institution or even one person taking high risks for conservative portfolios of municipalities and local public authorities.

Moreover, with regard to the MiFID classification of professional ‘per se’, it could be argued that not every *per se* professional should be treated equally. For example, there is arguably a difference between a large corporate and an investment firm that deals solely for its own account. On the one hand, a large corporate is considered to be a professional and, therefore, able to bear any loss, but persons authorized to act on behalf of the large corporate may not possess the required knowledge and experience. On the other hand, an investment firm that deals for its own account may possess the required knowledge and experience but may not be able to bear all losses which may result from the risky trading activities. The assumption that a professional investor has sufficient knowledge and/or experience can lead to undesirable situations. A professional investor with insufficient knowledge and/or experience, but a high risk appetite and long investment horizon, could make an investment choice with a high return/risk strategy. It can be, therefore, be concluded that a one-sided legal distinction between ‘professional’ and ‘retail’ is insufficient. A difference in actual behavior, investment knowledge and experience entails that a careful selection process is necessary. In other words, the presumption whether an investor can be deemed to be a professional investor or not should be tested in one way or another.

10 per cent warning of professional clients

MiFID II contains provisions to provide explicit information and warnings (e.g. 10 per cent loss reporting). What is the effect of this type of information provision and warnings from a scientific point of view? Hart ‘t and Loonen (2018) place critical notes to the usefulness and necessity of such obligations. Is it possible to ensure that the professional client is protected against his own rashness or lack of insight? Or will these information and warning efforts be systematically ignored because of information overload or habituation?

There is cause to challenge whether a correlation between the cautioned and the possible consequences exists. The requirement to warn professional clients when their investment portfolio drops by 10 per cent or more seems to contradict the assumption that a professional client is ‘able to bear financial losses’. Such situations do not appear, therefore, to apply to professional clients. The professional client is also deemed to have sufficient knowledge and/or experience to make independent investment decisions. To warn them that investments may decrease in value should, therefore, be unnecessary. A subsequent warning that a decrease in value has occurred implies that the professional client is forced to act. We would suggest making the degree and nature of warning congruent with the actual knowledge and experience that applies to the professionally classified client.

Cost disclosures

The possibility to limit disclosures on costs and charges within a wholesale chain may seem logical. On one hand, this relates to the circumstances that a professional client may not require protection in the same way as the retail client. Cost disclosures may also be considered to be competitive sensitive information, and presumably, this is the main reason why professional clients choose to deviate from the costs disclosures obligations. On the other hand, however, full cost disclosure is the ultimate objective and is no different from that of a retail client. Costs and charges should be taken into account to enable a client to consider its investment decision. There is no reason why this should be different for a professional client. Furthermore, at the same time, the possibility to agree amongst professional clients not to provide full costs disclosures has an effect ultimately on costs disclosures where the end client is a retail client. For example, Investment Firm A which provides order execution services to Investment Firm B that ultimately has a retail client does not need to disclose certain costs, that is, implicit costs in the bid/ask spread, to Investment Firm B. Investment Firm B is then not able to disclose such costs to its retail client. In other words, the contractual freedom for an investment firm that provides services to a professional client to limit its cost disclosure may create problems or hamper full and accurate information on costs and charges to retail client further in the chain. In that sense, it can be advocated that within the professional market, costs disclosures requirements should be met in full, not to provide investor protection to the professional client, but to achieve full costs transparency throughout the chain. Moreover, the contractual freedom to deviate from full costs disclosures indicates that a professional client does not wish to receive full cost transparency which is not the case.

Concluding observations

The MiFID legislator has attempted to make a distinction between the treatment of professional clients and retail clients. Where a large degree of protection provisions applies for a retail client, an attempt has been made to limit these provisions for a professional client. Although the legislation itself is clear, strong reservations exists concerning the logic of the provisions and whether these provisions reflect the spirit of the legislation.

These reservations concentrate on a number of few themes. The first theme being the unnecessity of gathering specific information as certain aspects are supposed to be present. This relates not only to knowledge and/or experience, but also to the ability to bear losses. On one hand, professional clients are assumed to have sufficient knowledge and/or experience to understand the risks of their (intended) transactions. On the other hand, information about the risk appetite, investment objective(s) and investment horizon must be gathered. All of these aspects have a direct correlation to (the extent of) investment knowledge and/or experience and capacity to bear losses. This introduces the risk that sub-optimal investment choices are made, whereby 'legal cover-against-it' behavior and 'box-ticking' behavior prevails over an appropriate financial and economic investment service.

The difference between professional and retail classification cannot be found in balance sheet size or number of transactions of (significant) scope, but in demonstrable knowledge, experience and trading behavior. The explicit and automatic assumption of the presence of knowledge and experience does not do justice to the findings of academic research that show that the level of knowledge and experience is decisive for the degree of professionalism. A clear distinction between professional and retail investor should be made based on materiality.

Another theme is the warning obligations applicable under MiFID. Specifically, the 10 per cent threshold warning does not actually serve professional clients. On the other hand, disclosing costs should not be optional because they serve all clients, regardless of their classification.

While there is no doubt that it is necessary to comply with the rules of conduct to protect investors for whom it is most necessary, this does not detract from the fact that it is advisable to calibrate more adequately the requirements applicable to different categories of clients. The obligations imposed on investment firms in connection with professional clients create a confounded picture and allow for unnecessary ambiguity and may even result in damage and liability. In assessing the effectiveness of the MiFID guideline by the EU Parliament and EU Commission, these findings should be taken into account and should result in adaptation of the new MiFID guideline accordingly.

Notes

1. 'Impact assessment accompanying the original proposals for Directive 2014/65/EU and Regulation (EU)' (no. 600/2014, *p* 20-21).
2. For the purpose of this paper, we do not address the 'eligible counterparty' under MiFID.
3. Annex II MiFID Directive 2014/65/EU of the European Parliament and of the council of May 15, 2014.
4. Annex II MiFID II.
5. See Annex II MiFID II.
6. Article 56 Assessment of appropriateness and related record-keeping provisions (Article 25(3) and 25(5) of Directive 2014/65/EU) and Article 54 (3) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016 .
7. See ESMA Final Report Guidelines on certain aspects of the MiFID II suitability requirements of May 28, 2018, General Guideline 3 Sub 41, Page 42.
8. See ESMA Final Report Guidelines on certain aspects of the MiFID II suitability requirements of May 28, 2018, General Guideline 3 Sub 41, Page 42 and Article 54 (3) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016, where the presumption that an investment firm may assume that the 'per se professional client is financially able to bear any related investment risks consistent with its investment objectives only explicitly relates to the service investment advice, not portfolio management.
9. See Article 54(4) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
10. See Article 54(5) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
11. See Article 24 (3) MiFID II.
12. See also Article 24(14) MiFID II Directive which provides that "The delegated acts referred to in paragraph 13 shall take into account: (a) the nature of the service(s) offered or provided to the client or potential client, taking into account the type, object, size and frequency of the transactions; (b) the nature and range of products being offered or considered including different types of financial instruments; (c) the retail or professional nature of the client or potential clients or, in the case of paragraphs 4 and 5, their classification as eligible counterparties." Or see FCA Handbook COBS 4.2. where the FCA expressed: "So a communication addressed to a professional client or an eligible counterparty may not need to include the same information, or be presented in the same way, as a communication addressed to a retail client".
13. See Article 24 (4) MiFID II .
14. See Article 44 (2) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.

15. See Article 44 (2) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
16. See Article 44 (2) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
17. See ESMA Final Report ESMA's Technical Advice to the Commission on MiFID II and MiFIR December 19, 2014, ESMA/2014/1569, Pages 100-103.
18. See recital (64) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016:
19. Regulation (EU), no 1286/2014 of the European Parliament and of the Council of November 26, 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), L 352/1, December 9, 2014.
20. See Article 24 (11) MiFID II Directive 2014/65/EU.
21. See Article 50(1) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
22. See Article 50(2) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
23. See Recital (74) and Article 50 (10) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
24. See Article 27(1) MiFID II Directive 2014/65/EU.
25. Idem note 22.
26. See Article 66 (9) Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
27. See Article 3 Commission Delegated Regulation 2017/576 of June 8, 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the annual publication by investment firms of information on the identity of execution venues and on the quality of execution.
28. See Article 24(1) MiFID II Directive 2014/65/EU.
29. See Article 11(2) Commission Delegated Directive (EU) 2017/593 of April 7, 2016.
30. See Article 12(1) Commission Delegated Directive (EU) 2017/593 of April 7, 2016.
31. See Article 62 Commission Delegated Regulation (EU) 2017/565 of April 26, 2016.
32. See ESMA "Final Report, Guidelines on MiFID II product governance requirements" June 2, 2017, ESMA35-43-62.
33. See ESMA "Final Report, Guidelines on MiFID II product governance requirements" June 2, 2017, ESMA35-43-62.

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Corresponding author

Tom Loonen can be contacted at: Tom.Loonen@vu.nl