

MiFID Client Classification

Overview

The Markets in Financial Instruments Directive (MiFID) was issued by the European Commission in April 2004 as part of its Financial Services Action Plan. It will come into force on 1 November 2007 and replace the current Investment Services Directive (ISD).

One of the major changes introduced by MiFID is the client classification rules.

This brochure aims to explain a bit more about how the new system will work under COBS 3.

Moore Stephens LLP
St Paul's House
Warwick Lane
London EC4M 7BP
Tel: +44 (0)20 7334 9191
Fax: +44 (0)20 7248 3408
www.moorestephens.co.uk

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MiFID - Client Classification COBS 3

Under MiFID there will be three types of clients: retail, professional and eligible counterparty.

Essentially these classifications can be compared to the existing FSA categories of private customer, intermediate customer and market counterparty; however, it should be noted that there are several important differences and the boundaries between the MiFID categorisations are not the same as those under the existing COB rules. Criteria setting out how firms should classify clients is defined within COBS 3.

As with the current UK regime, the full range of protections applies to retail clients. More limited rules apply to clients classified as professional clients (such as financial institutions, large undertakings and government bodies). Also, under MiFID clients can request to be treated as though they fall within a different category to their default category and this can result in them being afforded more or less regulatory protections. However, the criteria and procedures for doing this are not the same as under the existing rules. MiFID also requires firms to notify clients of their rights to request a different categorisation and the consequences of doing so.

The new client classifications are detailed as follows:

Retail client

A retail client is defined by MiFID as any client who is not a professional client or an eligible counterparty.

Professional client

MiFID provides for two types of professional client; those that satisfy objective criteria and who will be considered a professional client automatically (known as per se professional clients); and those that may, on request, be considered a professional client (known as an elective professional).

A professional client is defined as an entity possessing the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs.

Per se professionals

These are defined as:

1. Entities that are required to be authorised or regulated to operate in the financial markets. The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned:

- entities authorised by a member state under a directive;
- entities authorised or regulated by a member state without reference to a directive;
- and entities authorised or regulated by a non-member state being:
 - a) credit institutions
 - b) investment firms
 - c) other authorised or regulated financial institutions
 - d) insurance companies
 - e) collective investment schemes and management companies of such schemes
 - f) pension funds and management companies of such funds
 - g) commodity and commodity derivatives dealers
 - h) locals
 - i) other institutional investors

2. Large undertakings meeting two of the following size requirements on a company basis:

- balance sheet total: €20,000,000;
- net turnover: €40,000,000;
- own funds: €2,000,000.

3. National and regional governments, public bodies that manage public debt, central banks, international and supranational institutions such as the World Bank, the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organisations.

4. Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

Clients not falling within this list are, by default, retail clients.

There are procedural requirements contained in the directive which will have to be followed in relation to client classification. Professional clients have to be informed of their classification and that they will be treated accordingly.

When notifying clients of their classification, firms should also highlight the clients' right to request a variation of the terms of the agreement in terms of their classification and the subsequent limitations resulting from a higher or lower degree of protection that would entail.

Moving between categories

Under MiFID, there is scope for certain clients to be treated as falling within a different category of registration. Clients can request that they are treated as a particular type of categorisation for different types of services or on a transaction by transaction basis. Where a client requests a different categorisation, a firm can choose whether or not to provide the services on that basis.

This will require detailed records to show what the client has requested and how the firm has satisfied itself that it has provided the correct level of protection.

Opting up - Elective Professionals

Retail clients can request that they are treated as professional clients and would then be known as 'elective professional' clients. However, the qualifying criteria is more detailed than under the existing rules for private clients to opt up to intermediate status, there are both qualitative and quantitative tests to pass.

As an elective professional, a client would waive its right to certain protections.

The qualitative test involves an adequate assessment of the expertise, experience and knowledge of the client. The client needs to be capable of making his own investment decisions and understand the risks involved.

The test needs to be applied to managers and directors of entities licensed under directives in the financial field.

If the person is an entity, the individual authorised to carry out transactions for the client should be tested.

In addition to the assessment mentioned above, there is an objective and quantifiable test which requires that, as a minimum, two of the following criteria should be satisfied:

- the client has carried out transactions, of significant size, on the relevant market, at an average frequency of ten 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 knowledge of the transactions or services envisaged;

The clients defined above may waive the benefit of the detailed rules of conduct, but only where the following procedure is followed:

- they must state in writing to the investment firm that they wish to be treated as a professional client, either generally or in respect of a particular investment service or transaction, or type of transaction or product;
- the investment firm must give them a clear written warning of the protections and investor compensation rights they may lose;
- they must state in writing, in a separate document from the contract, that they are aware of the consequences of losing such protections.

If clients have already been categorised as professionals under parameters and procedures similar to those above, it is not intended that their relationships with investment firms should be affected.

Opting down

Investment firms, either on their own initiative or at the request of a client, can opt the client down to either a retail or professional classification, but it is up to the investment firm to agree to a request from a client for a different classification thereby resulting in treatment as a different class of client. It is possible to change the treatment of clients on:

- a general basis;
- in respect of one or more services;
- in respect of one or more products;
- on a trade by trade basis.

Ongoing

Professional clients are responsible for keeping the firm informed about any change that could affect their classification. Should the investment firm become aware that the client no longer meets the initial requirements that made them eligible for professional treatment, the investment firm must take appropriate action.

Eligible counterparties

The remaining category of client is eligible counterparties. These are similar to the current FSA category of market counterparties and are considered to be the most sophisticated investors or market participants. As with professional clients there are two types of eligible counterparties, per se or elective. When carrying out services for an eligible counterparty a firm can apply a 'light touch' regulatory regime. However, this is limited to specific types of business. These are:

- execution of orders;
- dealing on own account;
- reception and transmission of orders;
- or any directly related ancillary service.

However, for all other transactions the normal protections apply.

The following entities will automatically be recognised as per se eligible counterparties:

- investment firms;
- credit institutions;
- insurance companies;
- UCITS and their management companies;
- pension funds and their management companies;

- other financial institutions authorised or regulated under community legislation or the national law of a member state;
- undertakings exempted from the application of MiFID;
- national governments and their corresponding offices including public bodies that deal with public debt;
- central banks and supranational organisations.

It will also be possible to recognise undertakings as elective eligible counterparties if they meet certain criteria. The requirements are:

- the client is a per se professional client (except for a per se professional client because it is an institutional investor); or
- the client requests such treatment and is an elective professional client.

A firm must obtain express confirmation from a client that it agrees to be treated as an eligible counterparty. This can be in the form of a general agreement or specifically for each transaction to be undertaken. A firm would also need to have adequate procedures and records to support their treatment of the client as an eligible counterparty, particularly clients established in other member states.

In the event that a firm's counterparty is located overseas, the firm should defer to the status of the other undertaking as determined by the law or measures of the member state where that undertaking is established. If the UK was to add its own criteria then one would still need knowledge of the other states' criteria to assess the validity of the classification. This could be an issue for a firm which has a client that can be an eligible counterparty under UK law but cannot be an eligible counterparty under the law of its own jurisdiction.

Transitional provisions

There is scope under MiFID to transition existing clients under the grandfathering provisions. The COBS Transitional Provisions documentation from the FSA currently details three ways in which a firm can take advantage of grandfathering:

These provisions apply only to clients existing at 1 November 2007.

1. **Automatic grandfathering**
Existing clients can be grandfathered to be automatically provided with the nearest equivalent COBS 3 categorisation to their previous categorisation.
2. **Transitional grandfathering**
Some existing clients will not map directly across to the MiFID categorisations. The general transitional grandfathering provisions enable a firm to transfer these clients across directly into the MiFID categories without re-categorising them. In some cases, this will require notification to be sent to the clients.
3. **Newly categorised**
Existing clients that do not map across and can not be grandfathered will be newly categorised and there are relevant notification procedures which need to be followed.

Where grandfathering is available, the client's MiFID categorisation will be effective until the firm becomes aware of changes in the client's circumstances or the client requests a different category.

General notifications

After 1 November 2007, a firm must notify each new client of its categorisation prior to the provision of services. The notification must be in a "durable medium" and must inform the client of any right they have to request a different classification, and of any limitations.

Record Keeping

A firm must make a record of the form of each notice sent to each client which includes:

- the categorisation of the client;
- evidence of dispatch;
- copy of any agreement entered into.

The record should be made at the time of the classification and should be retained for a relevant period after the firm ceases to act.

COB/MiFID 'maps' - Private Customer

CLIENT CLASSIFICATION COB 4 Private Customer	CLIENT CLASSIFICATION (MiFID) COBS 3	
	Retail Client	Per se Professional Client
An individual who is not a firm	→ No change	
An overseas individual who is not an overseas financial services institution	→ No change	
A client classified as private customer in accordance with COB 4.1.14R (opted-down)	→ No change	
Unincorporated associations with net assets of less than £5m	→ No change	If entity meets any of the following criteria: 1. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m 2. Is an entity required to be authorised or regulated to operate in the financial markets. It is unlikely that these entities will meet these tests and are therefore likely to remain as retail clients
Trustees of a trust (other than occupational pension schemes, SSAS's or stakeholder pension schemes) with assets of less than £10m	→ No change	
Partnership with net assets of less than £5m	→ Possible change	
Trustees of occupational pension schemes, SSAS's or stakeholder pension schemes with less than 50 members and assets under management of less than £10m	→ Change	Pension funds and management of such funds.
Specialist requirements for CTFs	→ No change	

COB/MiFID 'maps' - Intermediate Customer

CLIENT CLASSIFICATION COB 4 Intermediate Customer	CLIENT CLASSIFICATION (MiFID) COBS 3	
	Retail Client	Per se Professional Client
Local authority	→ Retail Client	
Public Authority	→ Possible change Becomes retail client unless:	Regional Government 1. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m; or 2. Is an entity required to be authorised or regulated to operate in the financial markets; or 3. National and regional government, public bodies that manage public debt
Body corporate whose shares are listed or admitted to trading on any EEA exchange.	→ Possible change Becomes retail client unless:	No change if meets any of the following criteria: 1. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m; or 2. Falls within the list of entities required to be authorised or regulated to operate in the financial markets.
Body corporate whose shares are listed or admitted to trading on primary board of any IOSCO country official exchange.	→ Possible change Becomes retail client unless:	
Body corporate (inc LLP) which has called up share capital or net assets of £5m.	→ Possible change Becomes retail client unless:	
Partnership with net assets of at least £5m.	→ Possible change Becomes retail client unless:	
Special Purpose Vehicle	→ Possible change Becomes retail client unless:	No change if it is: Institutional investor whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.
Trustee of trust (other than OPS/SSAS/Stakeholder pension scheme) with assets of at least 10 million (before deducting liabilities) (at time of classification or at any time during the previous 2 years)	→ Possible change Becomes retail client unless:	No change if meets any of the following criteria: 1. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m; or 2. Falls within the list of entities required to be authorised or regulated to operate in the financial markets.
Trustee of an OPS/SSAS/ Stakeholder pension scheme with at least 50 members net assets under management of at least £10m	→	Pension funds and management companies of such funds
A firm or overseas financial services institution under COB 4.1.7R	→ No change	

COB/MiFID 'maps' - Intermediate Customer (continued)

CLIENT CLASSIFICATION COB 4 Intermediate Customer	CLIENT CLASSIFICATION (MiFID) COBS 3 Retail Client Per se Professional Client	
Collective Investment Schemes	→ Possible change Becomes retail client unless:	1. The scheme or the manager is authorised or regulated; or 2. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m.
Expert private customer	→ Possible change Becomes retail client unless:	'Elective' professional client if has the expertise, experience and knowledge to be capable of making its own investment decisions: and in the course of this assessment meets at least 2 of the following criteria: 1. the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters. 2. the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds 500,000. 3. the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
A recognised investment exchange, designated investment exchange, regulated market or clearing house except when classified as a market counterparty under 4.1.8 AR	→	No change. Other authorised or regulated financial institutions.

COB/MiFID 'maps' - Market Counterparty

CLIENT CLASSIFICATION COB 4 Market Counterparty	CLIENT CLASSIFICATION (MiFID) COBS 3	
	Per se Professional client	Per se ECP
A properly constituted government (including quasi-governmental body or a government agency) of any country or territory	→ Change for non Art 24(1) Business. National and regional governments.	National governments and their corresponding offices.
A central bank or national monetary authority of any country or territory	→ Change for non Art 24(1) Business. Central banks.	No change for Art 24(1) Business. Central Banks.
A supranational whose members are countries/central banks/national monetary authorities	→ Change for non Art 24(1) Business. International and Supranational institutions such as the World Bank, the IMF, the ECB and the EIB and other similar international organisations.	No change for Art 24(1) Business. Supranational organisations.
State Investment body or body charged with management of public debt	→ Change for non Art 24(1) Business. Public bodies that manage public debt.	No change for Art 24(1) Business. Public bodies that deal with public debt.
Firms/overseas financial services institutions (except where COB 4.1.7R applies)	→ Change for non Art 24(1) Business. Entities which are required to be authorised or regulated to operate in the financial markets: credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and management of such schemes, pension funds and management of such pension funds, commodity and commodity derivative dealers, locals and other institutional investors.	No change if doing Art 24(1) Business and fall within Investment firms, credit institutions, insurance companies, UCITS and their management companies ⁷⁴ , other financial institutions authorised or regulated under Community legislation or the national law of a Member State.
Any associate or a firm (other than OPS firm)/overseas financial services institution if the firm or the institution consents	→ Will require new categorisation under MiFID.	
Large intermediate customers classified as market counterparty under COB 4.1.12R	→ Change for non Art 24(1) business. Meets large undertaking financial criteria (2 of the following): (i) Balance sheet total of 20m (ii) Net turnover 40m (iii) Own funds 2m.	

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