Financial Services Authority

Implementing MiFID's Client Categorisation requirements

August 2006

1 Overview

Introduction

1.1 Member States are required to finalise legislation to give effect to the Markets in Financial Instruments Directive (MiFID)[1] by 31 January 2007. The FSA (together with HM Treasury) have a programme for consulting on the necessary changes[2] to UK legal and regulatory requirements. To assist in the formulation of proposals for implementation to be consulted on in the Reforming COB Regulation Consultation Paper scheduled for October 2006, this paper sets out our likely proposals for implementing the MiFID client categorisation provisions and opens discussion on the issues arising. Industry has requested early sight of the key implementation issues relating to client categorisation because of the broad potential for these requirements to affect their business processes and, more widely, business models. This paper responds to that request.

1.2 To protect investors, MiFID requires investment firms to be authorised and to comply with various regulatory requirements including those concerning how business is conducted. MiFID recognises that investors have different levels of knowledge, skill and expertise and that regulatory requirements should reflect this. MiFID does this through the use of categories of client. The application of specific regulatory obligations under MiFID depends on a client's 'regulatory' category. This approach is broadly similar to that adopted under existing FSA rules, although there are important differences.

Purpose

1.3 In this paper we focus, in particular, on those areas that we understand to be of greatest interest to the industry, for example, because they are relevant to planning decisions. Firms need time to consider the impact of new legislation and effect changes to their existing processes and systems advance of the commencement of new rules.

1 Directive 2004/39/EC of 21 April 2004 ('MiFID Level 1'). MiFID will replace the Investment Services Directive (ISD) (Directive 93/22/EEC). References in this paper to 'Articles' are (unless otherwise indicated) references to Articles in MiFID Level 1. The Commission has also developed draft legislative proposals for implementing relevant aspects of MiFID Level 1 ('Level 2' measures); Draft Commission Directive Implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive, published on 30 June 2006. We set out the provisions relevant to client categorisation in Annex A.

2 Our consultation approach is set out in the Joint Implementation Plan published on 14 May 2006 and in paragraphs 1.9 – 1.12 of CP06/14 Implementing MiFID for Firms and Markets, published in July 2006.

1.4 In paragraphs 2.36 – 2.50, we also set out our current thinking on client classification for investment business which is outside the scope of MiFID (e.g. under Article 3) or where the business is not a MiFID service or activity.

1.5 This paper is not a consultation document; there are no proposed rules or guidance. We will formally consult on our proposed rules in the Reforming COB Regulation Consultation Paper (the COB CP) due to be published in October 2006.

1.6 This paper sets out our current views on:

- MiFID's client categorisation provisions, supported by supplementary FAQs (Chapter 2 and Annex A);
- MiFID's transitional provisions which grandfather certain clients (Chapter 3);
- MiFID's definition of client, investment services and investment activities (Chapter 4);
- Article 20 of MiFID and retention of existing COB provisions - COB 2.3 (Reliance on others) and COB 4.1.5R (Agent as client) (Chapter 5); and
- possible impacts on other parts of the existing regulatory framework (Chapter 6).

Approach to Implementation

1.7 The likely proposals for implementing MiFID set out in this paper reflect the guiding principles, as set out in CP06/14 (paragraph 1.9). In the main, our approach is to copy out the MiFID provisions, replacing the existing client classification framework set out in our Conduct of Business Sourcebook (COB) with the MiFID client categorisation provisions using the MiFID categories and terminology. We aim to be pragmatic and proportionate. For example, our proposals anticipate making full use of all available transitional provisions and discretions.

Summary: categorisation under MiFID

1.8 MiFID adopts two main categories of client: retail and professional. There is a separate and distinct third category for a limited range of business: eligible counterparty (ECP). As with the existing COB classification regime, MiFID attaches different regulatory protections to each of these categories - with the result that those falling within the retail category - the less experienced, knowledgeable and sophisticated investors will be afforded a higher level of protection than that afforded to investors in the professional or ECP category.

1.9 The classification regime used in existing FSA rules[3] and the MiFID categorisation regime differ in several key respects:

3 COB4.1.

Boundaries between categories

- The boundaries between the three MiFID categories are not the same as those under existing COB provisions. Some clients may, therefore, fall into a category under which they will be afforded a different level of regulatory protection.
- Unlike the existing COB market counterparty category, the ECP category is available for a limited range of investment business. For other MiFID business, clients currently classified as market counterparties may, under MiFID, be required to be classified as professional clients.

Changes in criteria and procedures

- As under existing COB provisions, MiFID permits clients to be treated as though they fall within a different category to their default or initial categorisation with the result that they will be afforded additional or fewer regulatory protections. However, the criteria and the procedures for doing so are not the same as in existing COB. In particular, MiFID introduces a quantitative test for retail clients requesting professional client status.
- Under MiFID, investment firms are required to notify their clients of their right to request a different categorisation and any consequential limitations on the regulatory protections.
- MiFID provides that (in certain circumstances) it is the law of the Member State in which a professional client (or undertaking that can be treated as a professional client) is established that will determine whether that professional client can be treated as an ECP.

More retail clients

- MiFID introduces new quantitative thresholds for 'large undertakings' and a quantitative test for retail clients requesting treatment as a professional client. As these thresholds are higher than those in existing COB, we expect there to be more clients categorised as retail under MiFID than as private customers under existing COB.

1.10 More generally, the substantive conduct of business requirements under MiFID do not attach to clients in MiFID categories in the same way as under existing COB. For example, best execution, suitability and certain disclosure requirements will apply to business carried on with professional clients; under existing COB, intermediate customers can opt out of these requirements. Under MiFID, the conflict of interest requirements apply to business with eligible counterparties; under existing COB, conflicts of interest requirements do not apply to business with market counterparties. Chapter 6 provides more detail on these differences.

Who should read this paper?

1.11 This paper is important to all firms subject to MiFID. Firms that are unsure whether MiFID applies to them should refer to our draft Perimeter Guidance[4]. The precise impact of these proposals on each investment firm is likely to vary, depending on the nature of a firm's business and the size and breadth of its existing client base.

1.12 Firms outside the scope of MiFID will find this paper relevant as they may deal with and/or be categorised by MiFID investment firms, or may carry on 'designated investment business',[5] which will be affected by proposals for non-MiFID client classification.

Next steps

1.13 As stated above[6], this is not a formal consultation paper but we recognise that client categorisation is a significant issue for firms. We therefore invite comments and feedback on the views and issues set out in this paper. Firms can send their comments electronically to client.categorisation@fsa.gov.uk or to The Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS FAO: Alistair Wellmann. So that we can consider responses in developing our proposals for formal consultation, please send your responses to us as soon as possible and in any event no later than 25 September 2006.

1.14 We will continue to discuss emerging technical and interpretative issues with industry groups.

4 CP06/9 Organisational systems and controls, Chapter 10, CAD/MiFID perimeter guidance and Annex 5 (draft amendments to PERG).

5 FSA Glossary.

6 Paragraph 1.5 above.

2 Client categorisation under MiFID

2.1 This chapter describes the provisions in MiFID which concern the categorisation of clients, including key concepts and terminology[7] and compares them to existing COB provisions.

2.2 The full text of the relevant provisions of the MiFID Level 1 and Level 2 Draft Implementing Directive[8] are set out in Annex B of this paper.

Classification under COB

2.3 There are three categories of client under the existing client classification provisions in COB[9]: private customers, intermediate customers and market counterparties. By differentiating between three categories of client, our existing regulatory requirements are tailored so as to provide a balanced regulatory framework with different regulatory treatment for clients which reflects their knowledge, expertise and experience.

- *Private customers* are less sophisticated investors who are accordingly afforded the greatest degree of regulatory protection.
- *Intermediate customers* are more experienced investors and they will generally either have appropriate expertise in-house or will have the means to pay for professional advice when this is needed.
- *Market counterparties* are experienced in financial products and markets. They are either clients sufficiently sophisticated to operate within a 'light-touch' COB regime without the application of regulatory protections or they are counterparties (mainly authorised firms) operating within the inter-professional regime[10].

7 The FAQs in Annex A provide supplementary explanations to some of the technical issues raised in this Chapter.

8 MiFID: Article 24 (Transactions executed with eligible counterparties) and Annex II (Professional clients for the purpose of this directive). Draft Implementing Directive: Article 28 (Information concerning client classification) and Article 50 (Eligible counterparties).

9 COB 4.1 Client classification.

10 The following FAQs are indicative of the questions which we have been receiving from the industry and various trade bodies. The responses given in these FAQs represent the FSA's preliminary views on certain specific topics which are reflected in this paper and will be the subject to consultation in the October Reforming COB Regulation CP.

Categorisation under MiFID

2.4 The MiFID client categorisation provisions adopt the same broad regulatory objective – to allow for the tailoring of regulatory requirements according to the knowledge and experience of clients through the use of client categories[11].

2.5 MiFID introduces two main categories of client (retail clients and professional clients), and a separate and distinct third category for a limited range of business (eligible counterparties). Different levels of regulatory protection attach to each category and hence to clients within each category.

- Retail clients are afforded the most regulatory protection.
- Professional clients are considered to be more experienced, knowledgeable and sophisticated and able to assess their own risk and are afforded fewer regulatory protections.
- Eligible Counterparties ('ECP') are investment firms, credit institutions, insurance companies, UCITS and their management companies, other regulated financial institutions and in certain cases, other undertakings. MiFID provides a 'light-touch' regulatory regime when investment firms bring about or enter into transactions with ECPs.

Key message: The boundaries between categories of client under MiFID and COB are different. Similar clients may fall into a MiFID category that requires them to be afforded additional regulatory protections when compared to their classification under COB.

2.6 The table in Annex D sets out our analysis of the 'map' between existing COB categories and those under MiFID, illustrating the differences between boundaries. It shows where an existing COB classification is directly equivalent to a MiFID client category, i.e. where there is a direct route map between an existing COB classification and a MiFID category. Annex D also shows where there is no direct route map from an existing COB classification to a MiFID category. For these circumstances, we propose to put in place transitional arrangements. Chapter 3 explains our likely proposals for transitional arrangements available to firms for their existing clients.

Retail and professional clients

2.7 Professional clients[12] are considered to possess the experience, knowledge and expertise to make their own investment decisions and assess the risks inherent in their decisions. MiFID recognises certain persons as having these qualifications and automatically classifies them as professional clients. These per se professional clients, listed in Annex II.I to MiFID, are:

11 MiFID, Recital 31 'measures to protect investors should be adapted to the particularities of each category of investors'.

12 MiFID Article 4(1)(11) 'Professional client' means a client meeting the criteria laid down in Annex II.

- Entities which 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 and regulated by a non-Member State:
  - credit institutions;
  - investment firms;
  - other authorised or regulated financial institutions;
  - insurance companies;
  - collective investment schemes and their management companies;
  - pension funds and their management companies;
  - commodity and commodity derivative dealers;
  - locals;
  - other institutional investors.
- Large undertakings meeting two of the following size requirements on a company basis:
  - balance sheet total of €20m,
  - net turnover of €40m,
  - own funds of €2m[13].
- National and regional governments, public bodies that manage public debt, central banks and international and supranational institutions.
- Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

2.8 Any clients not falling within this list are, by default, retail clients[14].

Key message: We expect a greater number of clients (in particular, small corporate clients) to fall within the retail client category than the existing private customer category under COB, for two reasons:

- Like COB, MiFID has a professional category based on size (large undertaking). However, the MiFID size thresholds are higher than the existing thresholds in COB[15]; and
- Under MiFID, the size thresholds apply on a company by company basis rather than a group basis as is the case under COB.

13 See Q4 in Annex A for further details.

14 MiFID Article 4(1)(12) 'Retail client' means a client who is not a professional client.

15 COB 4.1.12R Large intermediate customer classified as a market counterparty.

Eligible counterparties

2.9 ECPs are considered to be the most sophisticated investor or capital market participant.

2.10 Article 24 of MiFID permits those investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or receive and transmit orders, to bring about or enter into transactions with ECPs without complying with certain of the conduct of business obligations in MiFID. The list of entities automatically recognised as ECPs (*per se* eligible counterparties) are[16]:

- investment firms;
- credit institutions;
- insurance companies;
- UCITS and their management companies;
- pension funds and their management companies;
- other financial institutions authorised and regulated under Community legislation or the national law of a Member State;
- undertakings exempted from the application of MiFID under Article 2(1)(k) or (l);
- national governments and their corresponding offices, including public bodies that deal with public debt;
- central banks and supranational institutions.

2.11 Note that this 'light-touch' ECP regime is limited to specific types of business. These are:

- executing orders on behalf of clients; and/or
- dealing on own account; and/or
- receiving and transmitting orders.

2.12 The ECP regime in Article 24 is broadly similar to inter-professional business[18]. However, the ECP regime differs from the existing COB regime for market counterparties (i.e. business outside inter-professional business under MAR). Under COB, a client can be classified as a market counterparty for all designated investment business, with the result that a number of additional COB protections are 'switched off' beyond those that are disapplied for business with an intermediate customer.

16 MiFID Article 24(2).

17 MiFID Article 2(1)(k): 'persons whose main business consists of dealing on own account in commodities and/or commodity derivatives. This exception shall not apply where the persons that deal on own account in commodities and/or commodity derivatives are part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC'; MiFID Article 2(1)(l): 'firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets'.

18 COB 1.3.4R Inter-professional business.

MiFID does not contain an equivalent to the regime for business with market counterparties under COB. Article 24 is relevant only where an investment firm brings about or enters into transactions with an eligible counterparty[19].

2.13 The existing definition of inter-professional business includes giving or agreeing to give transaction specific advice[20]. However, 'investment advice' under MiFID[21] falls outside the ECP regime except when it is an ancillary service directly related to a transaction with an ECP. And, although the definition of investment advice under MiFID is broadly similar to the existing FSMA definition of investment advice[22], under MiFID, investment advice is narrower, in that it is limited to 'personal' recommendations.

Key message: Outside the limited range of ECP business, an undertaking will need to be categorised as a professional or retail client for MiFID business.

2.14 In respect of transactions with ECPs and related ancillary services, the firm does not have to meet the obligations as set out in Articles 19 (COB obligations), Article 21 (Best execution) and Article 22(1) (Client order handling) of MiFID[23]. For example, in our view it would be possible for an investment firm to agree with an ECP that, in respect of such business with that ECP, only the obligations under Article 21 (best execution) would be 'switched off', with the effect that the firm would comply with (and the ECP would have the benefit of the protections in) Articles 19 and 22(1). This would offer investment firms considerable flexibility in dealing with eligible counterparties. As ECPs are to be treated as clients under MiFID where they fall within the definition of a client (i.e. where they receive an investment or ancillary service)[24], so the other MiFID obligations attaching to clients would continue to apply – for example, those concerning record keeping, client assets and conflicts of interest.

Moving between categories

2.15 Under MiFID, there is scope for certain clients to be treated as falling within a different category i.e. to increasing or decreasing the levels of regulatory protections afforded.

Key message: MiFID provides considerable flexibility to move between categories provided certain criteria are met. Professional clients and retail clients can move between categories either generally, or in relation to one or more particular services or transactions, or one or more types of product or transaction. Also, an ECP can request treatment as a professional or retail client either generally or on a trade-by-trade basis.

19 Bringing about or entering into transactions would cover dealing on own account, reception and transmission of orders and execution of orders. The ECP regime also applies to ancillary services directly related to transactions falling within the scope of the ECP regime. Ancillary services include corporate finance advice under section B(3) of Annex I and general recommendations under section B(5). These are therefore advisory activities that could fall within the ECP regime – provided they do not amount to personal recommendations under Article 4(1)(4) of MiFID and Article 52 of the Draft Implementing Directive.

20 FSA Glossary.

21 MiFID Article 4(1)(4) and Article 52 of the Draft Implementing Directive.

22 Article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)

23 See MiFID Recital 41. Article 24(1) provides that firms authorised to execute orders on behalf of clients and/or to deal on their own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1). In our view, it would also be possible for an investment firm to agree with an ECP that in respect of the business with that ECP, it would comply with any one or more of these obligations. We would expect a firm to clearly document the scope and effect of any such arrangements.

24 MiFID Recital 40: 'For the purposes of this Directive eligible counterparties should be considered as acting as clients'.

2.16 Importantly, where a client requests a different categorisation, an investment firm has the choice whether to provide services on that basis. If the firm does not agree, the client will need to source services with the desired level of protection elsewhere.

2.17 Article 28(3) of the Draft Implementing Directive confirms that an investment firm can unilaterally decide to treat any or all of its clients as retail clients if it chooses to do business on that basis. Firms which choose to do so are likely to be able to simplify their internal processes relating to, and dependent on, client classification.

Retail clients requesting treatment as 'elective' professional clients

2.18 Retail clients can request treatment as professional clients. We refer in this paper to these clients as 'elective' professional clients. Although broadly similar to the existing criteria for 'expert private customers'[25], the qualifying criteria for a retail client to become an 'elective' professional client are more detailed under MiFID than under our existing COB rules.

2.19 The existing COB rule is based around a qualitative assessment, requiring the firm to take reasonable care to determine that 'the client has sufficient experience and understanding to be classified as an intermediate customer'. Existing guidance explains that the client's experience, trading history and financial standing are relevant factors in performing this assessment.

2.20 Under MiFID, investment firms must take reasonable care to ensure that a retail client requesting treatment as an 'elective' professional client is able to meet the 'qualitative' criteria and, as part of these criteria, a separate '*quantitative*' test. The qualitative assessment requires the firm to undertake 'an adequate assessment' of the expertise, experience and knowledge of the client' to give 'reasonable assurance, in the light of the nature of transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved'[26].

2.21 In assessing the client's expertise, experience and knowledge, the client must satisfy at least two of the following *quantitative* criteria:

- 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;
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 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.

25 COB 4.1.9R Expert private customer classified as an intermediate customer.

26 MiFID Annex II.II.1.

2.22 A client must state in writing that it wishes to be treated as a professional client. The investment firm must give a clear written warning of the protection and investor compensation rights the client will lose. Also, the client, in a separate document from the contract, must state that it is aware of the consequences of waiving the retail protections.

Per se professional clients requesting treatment as a retail client

2.23 *Per se* professional clients can request the additional regulatory protections afforded to retail clients in relation to one or more particular services or transactions, or in relation to one or more types of product or transaction. MiFID is clear that the professional client is responsible for making this request when it is unable to properly assess or manage the risks involved.

2.24 The firm and the client must enter into a written agreement confirming that the client will not be treated as a professional client and stating whether the retail classification relates to one or more particular services or transactions or one or more types of product or transaction.

Per se and 'elective' professional clients requesting treatment as ECPs

2.25 Article 24(3) and Article 50 of the Draft Implementing Directive allow clients not falling within the list of *per se* ECPs in Article 24(2) to be recognised as ECPs. So most *per se* professional and elective professional clients may agree to be treated as an ECP[27]; but the investment firm must obtain express confirmation from the client (which can be either in a general agreement or in respect of an individual transaction).

2.26 Member States have discretion whether to implement Article 24(3) and Article 50 of the Draft Implementing Directive. We propose to take full advantage of these discretions to give clients the maximum flexibility to be treated as ECPs and facilitate firms' undertaking business on an ECP basis.

2.27 Other Member States may choose not to do this. Article 24(3) specifies that investment firms, when dealing with prospective counterparties located in other jurisdictions, will need to 'defer to the status of the other undertaking as determined by the laws or measures of the Member State where the undertaking is established' to determine on which basis they can deal with them. For example, a UK investment firm wanting to do business with an undertaking located in another Member State will have to defer to the categorisation as set by that Member State.

2.28 In our view, investment firms would need to have adequate procedures and records supporting their treatment of an undertaking as an ECP, particularly undertakings established in another Member State[28].

27 Except that Article 50(1) of the Draft Implementing Directive limits the right to request treatment as an ECP in two ways. It is only available to 'undertakings', therefore private individuals and other persons who are not 'undertakings' cannot be treated as ECPs under any circumstances. Secondly it is only available to those professional clients listed in paragraphs 1, 2 and 3 of Annex II.I of MiFID (which does not cover unregulated institutional investors whose main activity is to invest in financial instruments and special purpose vehicles) or retail clients that have been treated as elective professional clients under Annex II.II of MiFID Level 1.

28 A number of jurisdictional issues remain open which will need to be agreed between the Member States. For example, which rules would apply to the overseas branches of UK firms and the UK branches of overseas firms, in particular whether the primary ability to determine whether a client can be an ECP rests with the firm's home Member State or the branch Member State.

ECPs requesting treatment as a professional or retail client

2.29 ECPs may request more protective treatment and gain the protections provided by Articles 19, 21 and 22(1). Article 50(2) of the Draft Implementing Directive clarifies that ECPs can request treatment as a retail client[29] or as a professional client. Under Article 28(2) of the Draft Implementing Directive, an investment firm is required to notify a client of its ability to do so with the relevant notifications for new professional clients.

Client categorisation: notification obligations

2.30 Annex II of MiFID sets out the notifications that need to be sent to professional clients. There are complementary notification obligations in Article 28(1) and (2) of the Draft Implementing Directive which require investment firms to notify new clients, and existing clients which the firm has 'newly categorised'[30] (as retail clients, professional clients or ECPs), of their categorisation, their right to request a different categorisation and any limitations on protection that that categorisation would involve. This information will help clients understand the basis on which they are categorised, what it means for them and their options concerning that categorisation.

2.31 The existing COB rules contain client notification requirements only in respect of expert private customers and large intermediate customers[31]. So, firms will need to revise their documentation and procedures to ensure that all new and 'newly categorised' clients are sent the relevant notifications required by MiFID and obtain client agreement where necessary.

2.32 Annex C sets out the notification requirements for new retail clients, professional clients and ECPs. Firms should refer to Chapter 3 which sets out the transitional arrangements and notification obligations for existing customers.

Monitoring and organisational obligations

2.33 MiFID requires firms to implement appropriate written internal policies and procedures to categorise their clients[32]. And requirements under Article 19(1)[33] and organisational requirements under Article 13(2)[34] will also be relevant, in particular when firms seek to rely on Annex II procedures. But MiFID specifically places responsibility on professional clients to keep firms informed about any change which could affect their current categorisation. Nevertheless, if an investment firm becomes aware that the client no longer fulfils the initial conditions[35] qualifying them for treatment as a professional, the investment firm is also required to take appropriate action.

29 Article 50(2), Draft Implementing Directive.

30 See paragraphs 3.8 and 3.17.

31 COB 4.1.9R(1)(b) and COB 4.1.12R(2) respectively.

32 MiFID Annex II.II.2 Procedure (final paragraph).

33 MiFID Article 19(1) Investment firms have the duty to 'act honestly, fairly and professionally in accordance with the best interests of its clients'.

34 MiFID Article 13(2) 'An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm'.

35 These 'initial conditions' are likely to be the quantitative thresholds for large undertakings and criteria for elective professional clients.

2.34 Our proposed implementation approach is to copy out the MiFID requirements. So we are not proposing to retain any requirements similar to those currently in COB 4.1.15R (1) which require firms to review the classification of their expert private customers annually to ensure that the classification remains appropriate. In the context of the tests for 'elective' professional clients, a client's expertise, experience and knowledge is unlikely to have decreased just because their portfolio has dropped in value below the quantitative threshold for one day.

2.35 However, where a firm obtains information from the client for other business reasons (for example as part of its anti-money laundering review) that are also relevant to its client category, the firm will need to capture this information to ensure that the categorisation remains appropriate.

Client categorisation for non-MiFID business

2.36 For non-MiFID business, it is for us to decide how the regulatory regime should be tailored to the needs of investors; whether a client classification regime is appropriate, and if so, what regime – the existing COB regime, the MiFID regime or some other. We recognise that many firms perform non-MiFID business as well as MiFID business with the same (or different) clients; some do not perform MiFID business at all. We also recognise that many MiFID products are substitutable for non-MiFID products and vice versa.

2.37 We see no reason to change our existing policy that regulatory protections should be tailored to the needs of investors through a client classification regime[36].

Options for non-scope business

2.38 On the nature of the client classification regime, we have identified four possible options for firms that do not fall within the scope of MiFID (non-MiFID scope firms) and those MiFID firms that do some non-scope business (mixed scope firms). These are:

- maintain the existing COB classification regime, eligibility criteria and processes for the non-MiFID business;
- adopt a single client categorisation regime using the MiFID criteria[37];
- use the nomenclature of MiFID categorisation to all non-MiFID business but provide modified definitions or criteria and the use of grandfathering, where appropriate; or
- allow existing non-scope and mixed scope firms the choice of adopting either the MiFID regime or the existing COB regime for all or part of their non-MiFID business.

36 Financial Services and Markets Act 2000 Section 5(2)(b).

37 However, our ability to have a single classification regime across the Handbook as a whole is constrained by other Directives, such as the Distance Marketing Directive (DMD), which sets out a client classification regime based on the concept of 'consumer' for the purposes of the provision of banking, credit, insurance, personal pension, investment or payment services by distance contract. A 'consumer' is defined in the DMD as any natural person who in distance contracts is acting for purposes which are outside his trade, business or profession. DMD Article 2(d).

2.39 The costs and benefits of each of these options impact differently on firms with different business models and client profiles - for example as between firms which are exempt, those that conduct primarily MiFID business with retail clients or those that conduct a more equal mix of MiFID and non-MiFID business. The costs and benefits for consumers may vary as well – for example as between retail, professional and ECP clients. Therefore any decisions should be informed by cost benefit analysis.

2.40 Under the first and fourth options, the existing COB provisions would be retained and sit in the handbook along with the new provisions implementing MiFID. A client could be classified twice – once for MiFID business and once for non-MiFID business.

2.41 Under the second option, there would be one set of categories – based on the MiFID nomenclature and criteria - namely: retail, professional and ECP.

2.42 Under the third option, there would be a single set of categories (based on MiFID nomenclature), but we could be more flexible about the circumstances in which, for non-MiFID business, clients fell within these categories. Clients could fall within different categories for different business purposes (e.g. retail for one type of business and professional for another) – as they could do under MiFID for MiFID business.

2.43 Of the options set out above, our initial preference is for the third. This option has the advantage of simplicity, avoiding the need for two sets of parallel requirements that achieve similar outcomes, whilst offering more flexibility than the second. For mixed-scope firms this would deliver long term cost savings from operating one, and not two, client categorisation regimes. This option would also avoid confusion and difficulties for mixed scope firms, and their clients, associated with the need to categorise potential or new clients before it is known what type of business they wish to do. Finally consumers are likely to find a single set of categories easier to understand than two.

Cost benefit analysis

2.44 Our CBA work on this area is not yet complete, however we have conducted preliminary work with members of the Association of Independent Financial Advisers and the Association of British Insurers.

2.45 We found there to be a majority preference for a single set of client categories based on the MiFID nomenclature. Of the reasons given, the procedural and practical complexities of operating two separate classification regimes was the most common. The mainly mixed-scope firms who supported a dual system of classification also had concerns about the additional costs of operating such a system.

2.46 Firms also indicated that a reclassification exercise is costly in time and effort and that notification to clients of a change in category and/or contractual terms would be costly.

Likely proposals

2.47 On the basis of this early work, our likely implementation proposals for non-MiFID business will use MiFID client categorisation nomenclature, but with modifications, such as the disapplication of the quantitative tests for opting up to professional status.

2.48 To keep costs of reclassification to a minimum our proposals are likely to make use of grandfathering[38].

2.49 The non-MiFID scope client categorisation issues for firms conducting business primarily with non-retail clients may be more complex, given the number of different industry sectors undertaking wholesale investment business across the MiFID perimeter. Detailed CBA will be undertaken to inform policy choices. The October CP will therefore cover our proposals for retail business only. Our likely proposals for non-retail business are planned for consultation in the second quarter of 2007.

Q1 Do you agree with our initial policy thinking to extend MiFID nomenclature to non-MiFID business, with measures to provide suitable flexibility?

Q2 Which aspect of the MiFID client classification provisions should we disapply to, or provide additional flexibility for, non-MiFID business?

Presentation of Handbook text

2.50 In the Reforming COB CP, the draft Handbook text implementing MiFID is likely to be expressed as applying equally to all scope and non-scope business. This has been done for two reasons – to simplify the drafting effort otherwise required in crafting complicated disapplication provisions in advance of policy decisions on the non-MiFID scope regime, and to simplify the presentation of the provisions being consulted upon.

38 See Chapter 3.

3 Existing clients: transistional arrangements under MiFID

Introduction

3.1 The industry has asked for our early views on the procedures for the re-categorising of existing clients into their MiFID categories. There is concern that the differences in category boundaries under the MiFID and COB[39] may require firms to review, 're-paper' and notify their existing clients of their MiFID categorisation, which would cost considerable time and resource.

3.2 As explained in Chapter 2, the existing COB client classifications and the MiFID client categories are broadly similar. Many clients who meet the criteria for a particular COB classification will fall within the corresponding MiFID category.

3.3 There is also substantial scope under MiFID to transition existing clients, which will help firms to mitigate the costs and effort required to re-categorise their existing clients. In this chapter, we present our likely implementation proposals which will make full use of these provisions and set out the relevant procedures for re-categorisation.

The MiFID transitional provisions: grandfathering

3.4 Grandfathering allows firms to transition their existing clients into the appropriate MiFID client category by continuing to use, or rely on, existing documentation or compliance work for an indefinite period.

Key message: In our view, there is scope for firms to grandfather many of their existing clients. However, the procedures for doing so vary for different types of client (in the main, depending on the client's categorisation).

3.5 Under our likely implementation proposals there will be three ways in which firms can take advantage of grandfathering:

- *Automatic grandfathering* Some existing clients 'map' directly to the corresponding MiFID category and can be automatically grandfathered from their existing COB classification to a corresponding MiFID category. Firms do not need to review, 're-paper' or notify these clients of the change to the MiFID category. (See paragraphs 3.8 and 3.12);

39 See mapping table, Annex D.

- *Transitional grandfathering* Some existing clients will not 'map' directly from an existing COB to a MiFID category. But by making use of the general transitional grandfathering provisions in MiFID[40], firms may be able to transition these existing clients directly into MiFID categories without a re-categorisation exercise. In some cases, firms may need to send notifications to these clients. (See paragraphs 3.10 and 3.14);
- Reviewed grandfathering Some existing clients will not 'map' from an existing COB to a MiFID category. Firms will have to review these clients to determine whether they fall within any transitional provision, if so, they will be able to be grandfathered to a MiFID category. Some form of notification is likely to be required. (See paragraphs 3.16 and 3.17); and
- *Newly categorised* Existing clients that do not 'map' and cannot be grandfathered in any of the above ways will be '*newly categorised*' under MiFID; relevant notification procedures will apply to these clients. (See paragraphs 3.8 and 3.17)

3.6 Grandfathering, where available, will be effective until either the firm becomes aware of, or the client notifies the firm of, information which will result in a different categorisation for that client or the client requests treatment as a different category.

3.7 In general, MiFID contains provisions which will require firms to notify their clients of changes to their categorisation and, in some cases, to obtain the client's consent. In addition, under MiFID the substantive conduct of business provisions do not attach to client categories in precisely the same way as under existing COB[41]. Therefore, firms may want to review the broader impact on their business of the MiFID requirements regardless of the available grandfathering arrangements discussed in this chapter.

Private customers to retail clients

3.8 MiFID provides firms with a simple optional approach to transitioning of existing clients – a firm can choose to treat some or all of its clients as retail clients[42]. To the extent that a firm chooses to do so, it will not need to do any further re-categorisation of existing clients or notify them of their MiFID category. For firms that do not want to take this approach, the following alternatives are available.

- Existing private customers that are individuals 'map' directly and may be automatically grandfathered to the retail client category under MiFID.
- Existing private customers that are undertakings do not 'map' directly to the retail client category[43]; firms may:
  - rely on Article 28(3)(b) of the Draft Implementing Directive and categorise some or all of them as retail clients; or

40 MiFID Annex II.II.2 (penultimate paragraph) and Article 71(6).

41 See Chapter 6 (Consequential impacts on other parts of the Handbook) for more detail on the changes to the application of the substantive conduct of business provisions.

42 MiFID Article 28(3)(b).

43 Such as partnerships or unincorporated associations with net assets of less than £5 million; trustees of a trust (other than occupational pension schemes, SSASs or stakeholder pension schemes) with assets of less than £10 million; and trustees of occupational pension schemes, SSASs or stakeholder pension schemes with less than 50 members and assets under management of less than £10 million.

– review the status of these clients – that is to 'newly categorise' them to determine whether to categorise them as retail or professional clients and send the required notifications under MiFID.

Expert private customers to 'elective' professional clients

3.9 Existing COB classification rules for 'experts'[44] are not precisely the same as those for the corresponding 'elective' professional client category under MiFID, particularly in relation to the quantitative criteria under MiFID. So, existing expert private customers do not map directly and cannot be automatically grandfathered to the 'elective' professional category under MiFID.

3.10 However, existing COB requirements involve an evaluation of a client's expertise, knowledge and experience similar to that under MiFID. Our likely implementation proposals will permit firms to make use of the transitional grandfathering provision in the penultimate paragraph of Annex II.II.2[45]. So, existing expert private customers will be able to be categorised as professional clients under MiFID[46].

3.11 MiFID does not require firms to notify these clients of their categorisation under MiFID.

Q3 Will firms notify existing private clients of their categorisation as retail clients or professional clients even if they are not required to do so under our rules?

Intermediate customers to professional clients

3.12 Only a few types of existing intermediate customer 'map' to the MiFID professional client category. These include local authorities, special purpose vehicles and regulated collective investment schemes. Under our likely implementation proposals, these clients will be able to be automatically grandfathered to the corresponding MiFID professional client category.

3.13 For other intermediate customers, firms may be able to use the transitional grandfathering provision in Article 71(6)[47] which permits these customers to be categorised as professional clients under MiFID[48].

3.14 Article 71(6) requires investment firms to '…inform their clients about the conditions established in the Directive for the categorisation of clients'. Any such notification would need to tell these clients:

44 COB 4.1.9R.

45 MiFID Annex II.II.2 (penultimate paragraph): allows clients already categorised as professionals under parameters and procedures similar to those for 'elective' professional clients to not be affected by new rules adopted pursuant to this Annex and to remain categorised as such.

46 This has been confirmed by the European Commission. Our view is that the provisions in COB 4.1.9R and 4.1.10G (Expert private customer classified as an intermediate customer) are 'similar' to the 'parameters and procedures' in Annex II.II.2 for elective professional clients. The existing rules require an assessment of the client's knowledge, expertise and experience and our criteria for this assessment are also similar to tests listed in Annex II.II.1.

47 Article 71(6) allows investment firms to continue to treat clients who have been categorised as professional clients as such provided the earlier categorisation has been granted on the basis of an adequate assessment of the expertise, experience and knowledge of the client.

48 In our preliminary view, where a firm has correctly classified and currently treats an existing client as an intermediate customer in accordance with our rules, this would be an 'adequate assessment of the experience, knowledge and expertise' of the client for the purposes of Article 71(6), permitting firms to grandfather intermediate customers over to professional clients.

- that they have been classified as professional clients under Article 71(6); and
- the main differences between the treatment of retail and professional clients.

Q4 What proportion of your existing intermediate customers will 'map' directly?

Q5 Will firms notify these clients of their categorisation as professional clients under MiFID even if they are not required to do?

Market counterparties (MCPs) to ECPs

3.15 Transitioning existing MCPs is less straightforward. As explained in Chapter 2, the ECP regime does not correspond to the MCP regime; the ECP regime is limited to certain types of business and particular clients. So, existing MCPs do not necessarily 'map' to ECPs under MiFID. Also, MiFID does not contain any relevant general grandfathering provisions.

3.16 To transition existing MCPs to ECPs, firms will first need to review their clients to determine whether:

- the business they conduct with each particular MCP falls within Article 24(1); and
- if so, the MCP falls within the list of entities capable of being treated as an ECP under Article 24(2) (*per se* ECPs) or 24(3) (elective' ECPs)[49].

3.17 Where these conditions exist, a firm can grandfather the MCP to the corresponding ECP category with no requirement to notify the ECP to the extent that the firm and the client previously did business under the MAR 3 regime for inter-professional business. This is because the notification obligation in Article 24(3) only relates to 'prospective counterparties'. Where these conditions are not satisfied, the MCP will need to be 'newly categorised'. Firms will need to assess whether the MCP meets the criteria for professional or retail clients and send the relevant notifications.

Q6 What proportion of your existing MCPs will require to be newly categorised? What proportion do you estimate will be categorised as (i) professional, or (ii) retail clients for all or part of their business? Will this be because of the nature of the business conducted or the nature of the entity?

49 In the case of a client falling under Article 24(3) located in a different Member State, the firm should confirm whether the regime of that other Member State prevents the client from being treated as an ECP (see paragraph 2.27).

4 The MiFID definitions of 'client', 'investment services' and 'investment activity'

Introduction

4.1 As foreshadowed in our Best Execution DP06/3[50], we recognise that the definition of 'client' and its relationship with the scope of the ECP regime is an important issue. It turns on the distinction between investment services and investment activities under MiFID. This chapter sets out our views on this and consequential issues.

Services versus activities - the general question

4.2 Under MiFID, an investment firm is subject to various requirements when it is providing investment services or performing investment activities. Other requirements apply to an investment firm when it is providing investment services but not when it is performing investment activities[51].

4.3 Annex I, Section A to the Level 1 Directive lists eight types of investment services and activities[52] but does not indicate which are 'services' and which are 'activities'. In our view some of these businesses may be conducted only by way of investment service – for example, portfolio management and investment advice. It is also our view that an investment firm could conduct other of the businesses listed in Annex I.A. as either investment services or investment activities. For these, whether the firm is providing a service or conducting an activity will, at least in part, depend on the nature of the relationship between the parties.

50 DP06/3 *Implementing MiFID's best execution requirements*.

51 The following MiFID requirements, at least in some respects, are limited to investment services business: suitability and appropriateness, conflicts of interest, inducements, financial promotion/marketing communications, investment research, client money and assets, information to clients and potential clients, client order handling including aggregation and allocation and reporting obligations. Other obligations under MiFID are not dependent upon there being a 'client' to whom investment services and/or ancillary services are being provided, including compliance, risk management, internal audit, senior management responsibility, personal transactions, outsourcing, the provision of information in a durable medium and aspects of record keeping. Client classification will also be relevant for issues falling outside of the scope of MiFID (for example, the scope of the FOS and FSCS and requirements on some firm's permissions).

52 The investment services and activities are: reception and transmission of orders in relation to one or more financial instruments, execution of orders on behalf of clients, dealing on own account, portfolio management, investment advice, underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis, placing of financial instruments without a firm commitment basis and operation of multilateral trading facilities. MiFID Annex I Section A.

4.4 The factor that is central to determining whether an investment firm is providing an investment service or performing an investment activity is the presence (or absence) of a 'client' relationship[53]. Criteria indicating that an investment firm has a client relationship with another person could include:

- the nature of the obligations that each person has agreed to undertake;
- whether the relationship involves some act or work to be done for the other person, for example:
  - customisation of a particular product or transaction to meet the needs of that other party;
  - where an investment firm 'works' a transaction that it enters into or brings about with another person; or
  - where an investment firm is providing a facility to the other person such as the facilitation of transactions or providing an opportunity to trade;
- the reasonable expectations of the parties as to their relationship, including any relevant communications between them (although a statement that there is no client relationship will not be conclusive if it is not consistent with the overall nature of the relationship between the parties)[54];
- whether an investment firm has agreed to treat a person as a retail or professional client;
- whether the investment firm holds itself out as providing services; and
- whether the relationship involves fiduciary, agency or similar obligations.

Key message: When an investment firm is only performing an investment activity without providing an investment service, it will have no client and other client protections will not apply.

4.5 As stated above[55], in our view, portfolio management and investment advice will always be conducted by way of investment services. On the other hand, 'dealing on own account' could be an investment service; but where there is no client relationship, dealing on own account could be a pure investment activity[56]. We recognise that a

53 MiFID Article 4(10). A 'client' for the purposes of MiFID is defined as any natural or legal person to whom an investment firm provides investment and/or ancillary services. The ancillary services are listed in MiFID Annex I Section B.

54 Clarity here is important. We would normally expect a firm to make it clear to the other party, where business is being conducted on the basis that no client relationship exists (particularly in circumstances where business could be conducted as either a service or activity), that the other person will not be treated as a client and that, as a consequence, that person will not be afforded client protections.

55 See paragraph 4.3.

56 See, in relation to 'activities', Revision of Investment Services Directive (93/22/EEC): Second consultation - Overview Paper, p. 20 which stated 'It is proposed to modify the status of dealing so that it becomes a core ISD activity – as opposed to a service – in respect of which the firm is acting exclusively as counterparty without being charged by the other party to the transaction to transact on its behalf. In its dealing activity the firm is not providing a service to its counterparties in the sense of acting on their behalf. As a consequence, the firm owes no agency obligations to counterparties to such transactions.' See, in relation to 'services', MiFID Article 4 (1)(7), the definition of 'systematic internaliser' which allows for the possibility of an investment firm that 'deals on own account by executing client orders outside a regulated market or MTF' and MiFID Article 24, which refers to the obligations of firms that deal on own account to comply with Articles 19, 21 and 22(1) of the Level 1 Directive (each of which is restricted to investment services). And further, see Recital 69 to the Level 2 Directive which provides that 'Dealing on own account with clients by an investment firm should be considered as the execution of client orders.' (emphasis added).

distinction between investment services and investment activities could have particular relevance where trading occurs between dealers whose relationship is in the nature of counterparty rather than firm and client or where the parties to the trade are brought together by an anonymous third party order matching service.

Key message: A firm dealing on its own account may be performing an investment activity without providing an investment service, depending on the nature of its relationship with its counterparty.

Another View

4.6 Another interpretation we have considered is that Article 24 of MiFID covers the totality of circumstances in which firms may deal on own account without providing the full complement of protections that MiFID requires (i.e. that all dealing on own account between counterparties should fall within the ECP regime). We do not think this view is correct.

Retail Clients

4.7 In our view, there is a strong presumption that an investment firm is providing an investment service where it is conducting any of the businesses listed in Section A of Annex I with a person who fits the MiFID criteria for a 'retail client'.

4.8 This would be the case even if the contractual provisions between the parties attempted to portray the relationship differently, for example, by indicating that no service is being provided, if the relationship was one which indicated a service was, in fact, being provided.

4.9 However, we do not believe there would be a client relationship if the firm is conducting business with such a person in circumstances that currently fall within existing COB definition of a venture capital contact and a corporate finance contact.

Eligible Counterparties

4.10 The MiFID client categorisation regime is designed to afford retail and professional clients the protections of the conduct of business rules. It also provides a 'light touch' regulatory regime for investment firms that enter into or bring about transactions with 'eligible counterparties'[47].

4.11 MiFID clarifies that ECPs are to be considered as acting as clients[58]. Therefore, although an investment firm providing investment services to an ECP will not need to comply with the requirements under Articles 19, 21 and 22(1)[59], other obligations

57 In addition to those who are per se eligible counterparties, Article 24(3) provides that Member States may also recognise as eligible counterparties certain persons who meet the criteria set out in Article 50 of the Draft Implementing Directive on the condition that the investment firm obtains the person's express confirmation that it agrees to be treated that way. Conversely, investment firms may agree to provide conduct of business protections to eligible counterparties that ask for treatment as professional clients (whose business with the investment firm is subject to Articles 19, 21 and 22(1)).

58 MiFID Recital 40.

59 MiFID Article 24(1).

under MiFID such as Article 13(3) and Article 18 (conflicts of interest) will continue to apply when a firm provides investment services[60].

4.12 For example, regulated portfolio managers will be authorised entities. Therefore they will be recognised as eligible counterparties under Article 24 of MiFID. Consequently, brokers providing investment services to them[61], such as executing orders or dealing on own account, will not be required to provide best execution or comply with other conduct of business protections. Regulated portfolio managers will have a right to request treatment as professional clients in order to receive those protections, but the brokers will not be required to agree to that request.

4.13 MiFID Article 24 does not prevent an investment firm from agreeing to comply with any of the obligations in Articles 19, 21 and 22(1) when it enters into or brings about transactions with ECPs.

Link to Best Execution

4.14 We are aware that the distinction between investment services and activities has particular relevance for the implementation of MiFID's requirements for best execution. Respondents to our best execution Discussion Paper have also raised interpretive questions with respect to the definition of 'client order' and the relevance of the provision on client instructions in Article 21(1). We are considering these issues and will provide feedback in the COB CP as part of our feedback on the DP.

60 MiFID Article 13(3) 'An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 18 from adversely affecting the interests of its clients.'

61 MiFID Article 24(1) refers to 'bring about or enter into transactions with' which covers executing orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders.

5 Three party arrangements and indirect customers

Introduction

5.1 Both MiFID and COB contain declaratory provisions concerning the regulatory responsibilities of firms who may be in a 'chain' for the provision of investment services. Broadly, their effect is to minimise unnecessary regulatory burdens by permitting one firm to rely on another's efforts or to allocate responsibility for compliance along the chain. The relevant provisions are:

- Article 20 of MiFID (Provision of services through the medium of another investment firm);
- COB 4.1.5R (Agent as client); and
- COB 2.3 (Reliance on others)

5.2 However, there are variations between the nature and the scope of application of these provisions. In this chapter, we explain our likely proposals for the implementation of MiFID Article 20 and its interaction with the current COB provisions (COB 2.3 and COB 4.1.5R), these COB provisions are also relevant to circumstances in which a firm is relying on someone other than the ultimate beneficiary of the relevant services. Although the broad aims of the MiFID and existing COB provisions are similar, in our view, the agent as client provisions are not inconsistent with Article 20 of MiFID, as they deal with different circumstances. Consequently we propose to retain them. For MiFID business, Article 20 covers much the same territory as existing COB 2.3. We propose to retain COB 2.3 only insofar as it is broader than MiFID. We invite comments on issues for non-MiFID business which arise.

COB 4.1.5R and Article 20

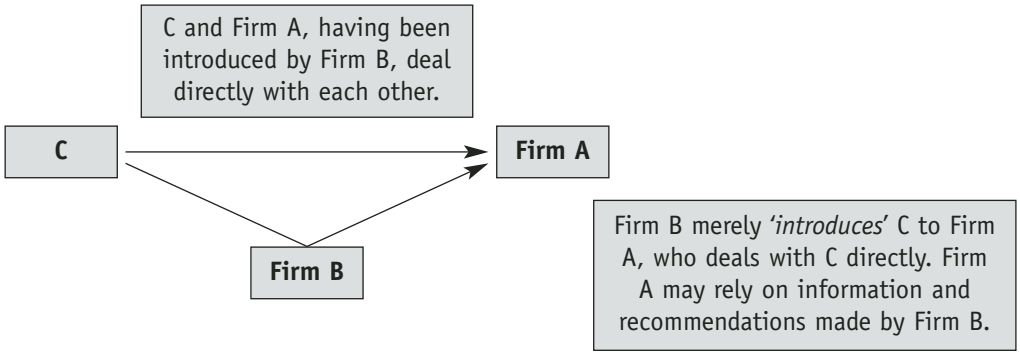
5.3 Article 20 of MiFID allows investment firms to rely on information and recommendations provided by another investment firm when conducting investment services and ancillary services for that firm on behalf of a client.

The effect is proportionate regulation – it avoids more than one firm having to comply with the same requirement in respect of the one client/transaction. However, it does not relieve the investment firm of the obligation to comply with other conduct of business requirements. Article 20 also clarifies that the mediating firm remains responsible for the appropriateness of any recommendation ensuring that the client receives the necessary protections in these circumstances[62].

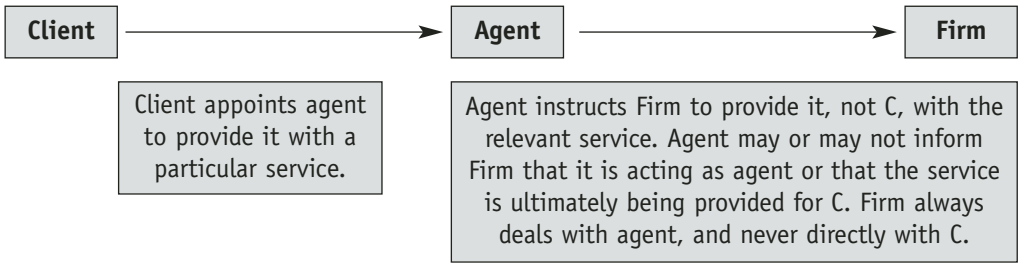
5.4 COB 4.1.5R currently applies where an investment firm receives instructions from another person that is acting as the agent for an underlying person ('C'). The effect of the agent as client provisions is to relieve the investment firm from certain COB obligations by providing that these can instead be fulfilled by the person acting as agent. As the agent will be treated as the client of the investment firm, not the underlying client, it is not a case of the investment firm receiving information from somebody other than its client, so Article 20 is not relevant. The agent as client rule is available where the agent is not an authorised person.

5.5 The difference between the two types of situation is summarised in the following diagrams.

Article 20 – 'mediation' arrangement



COB 4.1.5 – 'agent as client'



5.6 Where an arrangement is covered by COB 4.1.5R, the investment firm can treat the mediating firm as its client and must comply with the conduct of business provisions which attach to the client category of that agent – not the underlying client. If the agent is subject to conduct of business requirements in providing services to its client, it must comply with the requirements relevant to the services it provides to its client.

62 Our view is that the use of the term 'appropriateness' in the second paragraph of Article 20 carries its usual linguistic meaning and not as specifically defined under MiFID Article 19(5) in the context of the assessment of non-advised investment services. Where providing investment advice/a personal recommendation or carrying on portfolio management, suitability obligations will apply.

Proposal

5.7 Our present view is that we should retain COB 4.1.5R because of the strong practical benefits – particularly in the context of more complicated financial services involving 'chains' of parties.

5.8 COB 4.1.5 is not inconsistent with Article 20 or MiFID generally. Our view is that MiFID contemplates such an approach to the identification of the firm's client[63].

Q7 In what situations do you rely on COB 4.1.5R?

Q8 What would be the impact – on your costs and business model, should COB 4.1.5R be deleted?

COB 2.3 and Article 20

5.9 Under COB 2.3, a firm will comply with any rule in COB that requires a firm to obtain information, where the firm can show it was reasonable to rely on information provided in writing by another person.

5.10 Article 20 is broader than existing COB 2.3 in that firms may rely[64] on information regarding a client and on recommendations provided to the client by another investment firm. But it is also narrower in that it is restricted to information and recommendations received from a MiFID investment firm, whereas COB 2.3 is not. This has implications for our implementation approach in the following areas:

- whether a MiFID investment firm can rely on information and recommendations from or by a non-MiFID firm[65];
- whether a non-MiFID firm can rely on information and recommendations from a MiFID firm.

Likely Proposals

5.11 For MiFID business falling within the scope of Article 20, our likely implementation proposal will be to copy-out Article 20 in place of COB 2.3. We are also likely to propose retention of COB 2.3 in respect of information received from non-MiFID firms. MiFID firms will therefore be able to rely on information in the circumstances permitted under MiFID and existing COB and will also be able to rely on recommendations received from other investment firms.

63 Some of the categories of per se professional clients listed in Section 1 of Annex II are likely to be acting in a manner in which services are being provided by one firm through another. The explanatory text to CESR's consultation paper and final advice on the ECP regime contains passages which are consistent with our proposed approach. See, for example, CESR Technical Advice on possible implementing measures of Directive 2004/39/EC on Markets in Financial Instruments, CESR 05-290b, p. 48.

64 MiFID Article 20 permits firms to 'rely on' client information (or recommendations) provided by another without qualification: COB 2.3 permits firms to rely on information only to the extent that the firm can show it was reasonable to do so.

65 This includes both firms that are not carrying on MiFID business but also firms which are outside the scope of MiFID, for example by virtue of the MiFID Article 3 exemption.

5.12 We are still considering the position where the mediating firm is not subject to MiFID. This may in part depend on the extent to which the mediating firm is subject to requirements equivalent to MiFID. This issue will be revisited in the October CP.

Q9 Should we retain COB 2.3 for non-scope business or would it be appropriate for us to apply the Article 20 formula to all designated investment business?

Q10 What are the benefits in allowing within-scope firms to rely on recommendations made by non-MiFID scope firms as well as MiFID investment firms?

6 Consequential impacts on other parts of the Handbook

Introduction

6.1 Under MiFID, the regulatory protections afforded to clients in each client category does not mirror the situation under existing COB. In this chapter we explain these differences.

6.2 The main difference is for the professional client category – the conduct of business requirements which attach to the provision of investment services to professional clients are not the same as those which, under existing COB, apply for intermediate customers. As well, the ECP regime does not mirror the MCP regime under COB.

6.3 The main areas of change are:

- Best execution;
- Suitability and appropriateness;
- Information about financial instruments; and
- Conflicts of interest.

Best execution

6.4 Under the existing COB, intermediate customers may agree with a firm that best execution will not be provided. Some intermediate customers, including expert retail customers who have opted up to intermediate customer, agree to do business on this basis. Under MiFID, there is no provision for professional clients to agree with firms that best execution will not be provided.

Suitability and appropriateness

6.5 The MiFID suitability requirement is broadly similar to the existing COB suitability requirement, although MiFID is more prescriptive as to the criteria that must be assessed. An important difference is that, under MiFID, the suitability requirement applies for professional clients[66] where the firm is providing investment advice or

66 Under existing COB, suitability applies to non-insurers recommending life policies to intermediate clients and market counterparties.

portfolio management. For professional clients, the Draft Implementing Directive makes it clear that compliance with the suitability requirements should take account of the type of investment service provided, whether the client is a *per se* or 'elective' professional and whether the firm is entitled to assume the professional client has the necessary knowledge and experience or is financially able to bear the investment risks[67].

6.6 Appropriateness is a new requirement under MiFID and does not have a COB equivalent. It requires a firm, when providing investment services other than investment advice and/or portfolio management, to assess a client's knowledge and experience in the relevant investment field to establish whether the product or investment service provided is appropriate for the client. Under MiFID, the appropriateness requirement applies in respect of retail and professional clients. The Draft Implementing Directive allows a firm to assume that a professional client has the necessary knowledge and experience to understand the risks involved with the investment services or transactions for which they are classified as a professional client[68].

Information about financial instruments

6.7 Article 31 of the Draft Implementing Directive requires investment firms to provide clients with a general description of the nature and risks of financial instruments, taking into account whether a client is categorised as a retail or professional client[69]. This is different to existing COB, where risk warnings are only required for private customers.

Conflicts of interest

6.8 Under MiFID, the duty to identify and manage conflicts is owed to all clients – retail, professional or ECP. The existing conflicts management principle (PRIN 8) does not apply in relation to market counterparties. In addition, under MiFID, an 'interest' of the firm could arise from activities conducted by the firm or by other members of the firm's group.

MAR 3: Inter-professional conduct and ECPs

6.9 The ECP regime in Article 24 is, broadly the MiFID equivalent of inter-professional business under existing COB[70]. The inter-professional conduct (IPC) chapter in MAR3 sets out guidance on how our Principles for Businesses apply to inter-professional business and articulates good market practice. It sets out the standards we expect of firms in their bilateral dealings with market counterparties in relation to inter-professional business and recognises there is less need for consumer protection in these transactions. Our work on implementing the ECP regime has involved us considering the relevance of the IPC to this type of business.

67 Article 35(2) of the Draft Implementing Directive.

68 Article 36 (indent two) of the Draft Implementing Directive.

69 Article 31(1), Draft Implementing Directive.

70 COB 1.3.4R Inter-professional business. But note, to the extent that an investment firm may, under MiFID, be performing investment activities with a counterparty (where there is no client relationship), it may be conducting business that does not fall within the ECP regime.

6.10 Last year, we informally consulted with some market participants and advisers on the benefit of the IPC. There was no clear consensus of opinion. However, many of those consulted thought there was continuing value in retaining the rules and guidance relating to non-market price transactions, together with other guidance and there was no strong desire to see it reduced.

6.11 Our preliminary conclusion is that the case for retention of MAR3 is a weak one:

- some of the provisions will be unnecessary, given MiFID requirements; and
- others refer to market practices that have become standard and therefore, there is no longer any need for guidance.

6.12 Therefore, we are likely to propose deletion of the IPC as a separate chapter in MAR3 and to treat that material which may still be useful in the following way:

- guidance on the application of the Principles for Businesses be moved to PRIN;
- the rules and guidance relating to non-market price transactions will either be moved to COB or will be included, as best practice provisions, within our quarterly publication 'Marketwatch'; and
- 'best practice' provisions covering issues other than non-market price transactions will be set out in 'Marketwatch'.

Issues covered within 'Marketwatch' will not have the status of rules or guidance. Nevertheless, we believe there is merit in setting out our view of best practice, especially as the industry indicated, in informal consultations, that the current guidance is useful.

Q11 Do you agree that the IPC should be deleted from the FSA Handbook?

Q12 Which best practice topics merit inclusion in 'Marketwatch'?

Q13 Do you agree with retention of guidance on non-market price transactions to be included in COB or should it be included as information only in 'Marketwatch'?

Financial Ombudsman Service (FOS)

6.13 Under DISP 1, firms have obligations concerning complaints from 'eligible complainants' – that is, those who are eligible to refer their complaint to FOS. The criteria for such eligibility are set out in DISP 2.4 concerning the jurisdiction of FOS[71]. At present, the criteria are based, in part, on our existing client classification scheme – for example, they exclude intermediate customers and market counterparties.

6.14 However, as this paper has set out, this client classification scheme is to change for MiFID business and also for non-MiFID business. We are minded, therefore, to reflect these wider changes in DISP through a suitable amendment to the definition of eligible complainant, so as to retain a basic unity of approach between DISP and other areas.

71 For more information on the Financial Ombudsman Service refer to www.financial-ombudsman.org.uk.

6.15 This may mean, to the extent MIFID's 'retail client' may be somewhat broader than the current 'private client', there would be somewhat more eligible complainants than currently - which may lead to firms and FOS having to deal with somewhat more complaints than currently.

6.16 On the other hand, to the extent such new 'retail clients' are businesses, charities or trusts, many of them would remain excluded from being eligible complainants by the existing financial limits in DISP 2.4.3 (for example annual turnover of less than £1m for a business) - limits which we intend to retain[72].

6.17 We do not believe these changes would materially impact firms' obligations concerning complaints, FOS's scope, or consumers' rights to complain (and are minded that they be applied only in respect of complaints about acts or omissions occurring after MiFID is implemented). However, we are continuing discussion with FOS and other key stakeholders about this approach and are working to assess in more detail the potential effects and likely costs and benefits.

Q14 Do you agree with our proposed approach in relation to the financial ombudsman regime?

The Financial Services Compensation Scheme (FSCS)

6.18 The FSCS is the UK's statutory compensation fund for consumers who lose money due to the default of an authorised financial services firm[73]. Consumers who are able to benefit from the protection offered by the FSCS are known as eligible claimants. Unlike the FOS's regime, the definition of an eligible claimant is not linked to the existing COB client classification system, but is derived from the Investor Compensation Directive. Accordingly, we and the FSCS think that no changes will be required to the eligible claimant provisions.

72 See PS06/4 *Review of Compensation Scheme and Ombudsman Service limits and miscellaneous amendments to the Compensation Sourcebook* – Feedback on CP05/15.

73 For more information on the Financial Services Compensation Scheme, please refer to www.fscs.org.uk.

Frequently asked questions

How much can we rely on these FAQs?

The following FAQs are indicative of the questions which we have been receiving from the industry and various trade bodies. The responses given in these FAQs represent the FSA's preliminary views on certain specific topics which are reflected in this paper and will be the subject to consultation in the October Reforming COB Regulation CP.

Moreover, although MiFID sets out most of the key provisions and definitions, some provisions may be subject to further legislation by the European Commission. In addition to FSA guidance, MiFID provisions may also be the subject of guidance or communications by the European Commission or the Committee of European Securities Regulators (CESR).

Q1. From what date must the new client categories be applied?

1 November 2007, in relation to business falling within the scope of MiFID. We plan to consult on the position outside of the scope of MiFID in our October CP and in our Q2 2007 CP on non-scope business.

Type of per se professional clients

Q2. Which types of client fall into the definition of 'other authorised or regulated financial institutions' in MiFID Annex II.I (1)(c)?

The term 'financial institution' in not defined in MiFID. However, we believe it should be given a similar meaning as in Article 4(5) of the recast Banking Consolidation Directive (BCD) (Directive 2006/48/EC)

http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf

This interpretation would, however, exclude insurance and mortgage intermediaries, who are currently capable of being categorised as market counterparties under COB 4.1. Therefore in order to categorise insurance and mortgage intermediaries as ECPs they would have to (a) be 'undertakings' and (b) meet the quantitative criteria of Annex II for opting up to professional status before they could be treated as ECPs.

Q3. What does the term, 'undertaking', mean?

There is no clear definition of an 'undertaking' for the purposes of EU financial services legislation but elsewhere under Community law the term has been given different meanings for different purposes and it has been interpreted in different ways by the ECJ. For these purposes, we would read the term as excluding any natural person who is acting for purposes which are outside of his trade, business or profession.

Q4. In the definition of large undertakings, is the size of a corporate client falling into this category determined on a group basis or an individual entity basis?

The quantitative test for large undertakings is on a company basis, rather than on a group basis as currently under COB.

Q5. What do the terms 'balance sheet total', 'net turnover' and 'own funds' mean in the size requirements for large undertakings?

Whilst these terms are not defined in MiFID, we believe they should be given a similar meaning as in other EU Directives:

Balance sheet total is defined in Article 12(3) of the Fourth Company Law Directive (Directive 78/660/EEC)
http://europa.eu.int/eur-lex/en/consleg/pdf/1978/en_1978L0660_do_001.pdf

Net turnover is defined in Article 28 of the Fourth Company Law Directive (Directive 78/660/EEC)
http://europa.eu.int/eur-lex/en/consleg/pdf/1978/en_1978L0660_do_001.pdf

This definition forms the basis of s.262(1) of the Companies Act 1985. The EU definition of "net turnover" therefore corresponds to the 'turnover' line in the accounts of a UK company.

Own funds are defined in Articles 56 - 67 of the recast Banking Consolidation Directive (Directive 2006/48/EC)
http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf

Q6. What is the difference between the two types of 'other institutional investor' in the list of professional clients in Annex II.I?

The first category of 'other institutional investor' (Annex II.I (1)(i)) is a default category and will include investors who do not fall within other categories in Annex II.I, provided they are authorised and regulated.

The second category (Annex II.1(4)) covers investors who do not fall within other categories in Annex II.I and which are not authorised and regulated. It includes UK private equity funds and special purpose vehicles used in securitisations and other financing transactions.

Moving between categories

Q7. Do investment firms have to accept a request from a client to move between categories?

No. Although clients have the right to request a different categorisation, investment firms have the choice whether to accept the request to provide services on that basis. Where the firm does not accept, the client will need to source services with the desired level of COB protection elsewhere.

Q8. Do firms always have to wait for a request from a client or can they start treating their clients a particular way?

The Directive is generally silent on whether a firm can solicit a request from a retail client to be classified as an elective professional or as an ECP. Article 28 of the Draft Implementing Directive clarifies that investment firms can initiate the way they categorise their clients provided they are offering those clients a higher level of protection. For example, a firm can, of its own initiative, treat all of its clients as retail clients. However, the firm would need to ensure that it follows the relevant procedural requirements including the notification and client agreement obligations.

Where an expert retail client is classified as a professional client (Annex II.II to MiFID) or an ECP (Article 50 of the Draft Implementing Directive), there must be a separate request for classification from the client. Firms would have to ensure, however, that if initiating such a request - for example in their standard terms of business - such a 'request' would be in accordance with the requirement upon the firm to act honestly, fairly and professionally in accordance with the best interests of the client and otherwise met the requirements of the Unfair Contract Terms Act of 1977 and the Unfair Contract Terms in Consumer Contracts Regulations 1999.

Q9. MiFID permits clients to be categorised differently for different products and/or transactions. Such multiple categorisations may have related resource and systems costs. What is the FSA view on how firms should handle this process?

MiFID provides this flexibility provided certain criteria are met. Firms will need to decide for themselves whether their business model should permit their clients to take full advantage of this flexibility. This will likely depend on the costs of adopting such a business model and the costs of doing business on this basis. Firms do not have to accept a request from a client to move between categories for different products/transactions.

To the extent that the ability to opt for a lower degree of protection is dependent upon an evaluation of the knowledge, expertise or experience of the client, the firm will only be able to opt the client into that other regime to the extent this is warranted by the scope of the client's knowledge, expertise or experience. For example, the fact that the client is knowledgeable and experienced in relation to bonds does not necessarily mean they are knowledgeable and experienced in relation to equity derivatives.

Retail clients requesting treatment as 'elective' professional clients

Q10. Assuming the objective criteria can be met, does the FSA envisage that an 'adequate assessment of the expertise, experience and knowledge of the client' can be made by applying the same approach as in COB 4.1.10G?

Our view is that the MiFID test requiring the 'adequate assessment of the expertise, experience and knowledge of the client' involves considerations similar to those in existing COB 4.1.10G (expert private customers classified as intermediate customers), but a minimum of two of the quantitative criteria specified in Annex II.II.1 of MiFID must also be satisfied.

Q11. Is it enough that a retail client represents that it is able to meet the criteria to be treated as an 'elective' professional client under Annex II.II.2 or will an investment firm have to obtain evidence for the retail client to be treated in this way?

Annex II.II.2 clarifies that 'before deciding to accept any request for waiver, investment firms must take all reasonable steps to ensure that the client requesting to be treated as a professional client meets the relevant requirements..'. Also, investment firms will need to ensure that their 'written internal policies and procedures to categorise clients' are appropriate.

Our view is that investment firms should be able to demonstrate that they have the necessary information to ensure that the client meets the criteria to be treated as an 'elective' professional client. Firms will be able to rely on the information provided by clients (provided they have acted reasonably in so doing) but representation, on its own, may not be sufficient.

Q12. Does FSA expect firms to follow the fitness test suggestion made in Annex II.II.1?

The fitness test is one way in which a firm could assess expertise and knowledge. It is not, however, the only way, and firms may choose other methods, provided they satisfy the requirements of Annex II.II.1.

Q13. Annex II.II.1 states 'in the case of small entities, the person subject to the above assessment should be the person authorised to carry out transactions on behalf of the entity.' Does the FSA interpret this as meaning every factor must be measured by reference to the person, or might it allow the portfolio size and significant transaction test to be measured against the small entity concerned?

For small entities, the qualitative criteria can be fulfilled by an assessment of the 'expertise, experience and knowledge' of the 'person authorised to carry out transactions on behalf of the entity'. The quantitative criteria (i.e. portfolio size and significant transaction requirements) should be assessed by reference to the entity itself and not the individual authorised to carry out transactions.

Q14. Is the definition of small entity the same as that of small enterprise in the Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises?

It is our view that a small entity is any undertaking not satisfying the large undertaking test in Annex II.I (2). The wording of 2003/361/EC and MiFID are not the same so it cannot be assumed that the meaning is the same.

Q15. Does 'significant size' have the same meaning as under the Prospectus Directive?

The wording of the test in Annex II.II.1 is similar to that in the Prospectus Directive. We assume that this similarity is deliberate. However, the Prospectus Directive is limited to transactions in the 'securities market', whereas the wider scope of MiFID refers to transactions on the 'relevant market'.

Q16. When evaluating portfolio size, can a firm include only MiFID instruments and cash deposits?

Our preliminary view is that the size of a client's financial instrument portfolio should be limited to financial instruments, as defined in MiFID, and cash deposits.

Q17. Does the term 'carried out' in the first criteria of Annex II.II.1 include discretionary managed decisions in which the client plays no part or has no knowledge (other than by retrospective report)?

We do not believe 'carried out' includes discretionary portfolio management as the purpose of the test is to assess how frequently the client has been actively involved in the decision making process.

Q18. What form of consent will firms need from their retail clients who agree to waive the protections to be treated as 'elective' professional clients?

Where permitted by MiFID, consent to change of categorisation could be on a one-way basis. However, Annex II.II.2 envisages a positive statement in writing from a retail client confirming that they are willing to waive the regulatory protections afforded to retail clients and be treated as a professional client.

The confirmation from a retail client must be separate from any client agreement and there must be evidence of a positive action (for example, signature from the client) to demonstrate they understand the consequences of losing retail client protections.

Per se professional clients requesting treatment as a retail client

Q19. What does 'written agreement' mean in the context of professional clients being treated as retail clients?

Our initial view is that an investment firm is not required to obtain positive consent from professional clients before treating them as retail clients. So, a one-way written notice provided by the firm to the client would be enough if it makes it clear that the client is deemed to consent to the re-categorisation by conducting business with the firm after receipt of the notice.

Per se and 'elective' professional clients requesting treatment as ECPs

Q20. Is the FSA planning any quantitative thresholds in addition those in MiFID and the Draft Implementing Directive?

We are not likely to propose narrowing or limiting the ability of all professional clients to be treated as ECPs within the scope of MiFID. We are still considering our approach in relation to non-scope business.

Q21. Can all professional and retail clients move to ECP status?

Article 50(1) of the Draft Implementing Directive limits the right to request treatment as an ECP to 'undertakings', so natural persons acting outside of their trade, business or profession cannot be treated as ECPs under any circumstances. Only those professional clients listed in paragraphs 1, 2 and 3 of Annex II.I of MiFID may be treated as ECPs, which would exclude other institutional investors whose main activity is to invest in financial instruments.

Q22. Can a firm provide best execution to an ECP without treating the client as a professional client?

Article 24 provides that an investment firm executing orders on behalf of clients and/or dealing on own account and/or receiving and transmitting orders for persons who are eligible counterparties are not obliged to comply with the obligations under Articles 19, 21 and 22(1). If an investment firm agrees with its client that the client is to have the protections of Article 21 (best execution) or, alternatively, if it agrees with its client that the client is to have the protections of Article 19 (conduct of business) and Article 22(1) (client order handling), then the investment firm would be required to comply with those obligations. However, if this is the case, investment firms must ensure that they also comply with the requirement to notify the client of its classification and about any limitations to the level of client protection that this would entail.

Q23. What does 'express confirmation' mean in Article 24(3)?

This should be taken to mean some form of acknowledgement or active demonstration of consent by the client that it agrees to do business on this basis. Express confirmation cannot be obtained by reason of silence or lack of objection.

Client categorisation in trust arrangements

Q24. Who will be the client in a trust arrangement under MiFID?

We are still considering the application of MiFID to trustees.

Grandfathering existing clients: transitional arrangements under MiFID

Q25. How long would the grandfathering of clients under Article 71(6) last for?

Grandfathering under Article 71(6) will remain valid until a firm becomes aware during the course of its business that such a categorisation is no longer appropriate for the client or the client requests a different category, either generally or in respect of a particular transaction. In such circumstances, the firm should re-categorise the client.

Q26. Recital 59 of the Draft Implementing Directive is a grandfathering provision in respect of Article 19(5) (appropriateness). Does a client to which this applies still need to be categorised under MiFID for all requirements other than 19(5)?

Recital 59 does not affect client categorisation - all clients need to be categorised under MiFID.

MiFID client categorisation reference material

MiFID Level 1

(Directive of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (Directive 2004/39/EC)

Recital 31

One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties).

Recital 40

For the purposes of this Directive eligible counterparties should be considered as acting as clients.

Article 2: Exemptions

This Directive shall not apply to:…

(1)(k) persons whose main business consists of dealing on own account in commodities and/or commodity derivatives. This exception shall not apply where the persons that deal on own account in commodities and/or commodity derivatives are part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;

(1)(l) firms which provide investment services and/or perform investment activities consisting exclusively in dealing on own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets;…

Article 4: Definitions

2) 'Investment services and activities' means any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I;

3) 'Ancillary service' means any of the services listed in Section B of Annex I;

4) 'Investment advice' means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments;

5) 'Execution of orders on behalf of clients' means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients;

6) 'Dealing on own account' means trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments;

10) 'Client' means any natural or legal person to whom an investment firm provides investment and/or ancillary services;

11) 'Professional client' means a client meeting the criteria laid down in Annex II;

12) 'Retail client' means a client who is not a professional client.

Article 13: Organisational requirements

2. An investment firm shall establish adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and tied agents with its obligations under the provisions of this Directive as well as appropriate rules governing personal transactions by such persons.

Article 19: Conduct of business obligations when providing investment services to clients

3. Appropriate information shall be provided in a comprehensible form to clients or potential clients about:

- the investment firm and its services,
- financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies,
- execution venues, and
- costs and associated charges

so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently to take investment decisions on an informed basis. This information may be provided in a standardised format.

Article 20: Provision of services through the medium of another investment firm

Member States shall allow an investment firm receiving an instruction to perform investment or ancillary services on behalf of a client through the medium of another investment firm to rely on client information transmitted by the latter firm. The investment firm which mediates the instructions will remain responsible for the completeness and accuracy of the information transmitted.

The investment firm which receives an instruction to undertake services on behalf of a client in this way shall also be able to rely on any recommendations in respect of the service or transaction that have been provided to the client by another investment firm. The investment firm which mediates the instructions will remain responsible for the appropriateness for the client of the recommendations or advice provided.

The investment firm which receives client instructions or orders through the medium of another investment firm shall remain responsible for concluding the service or transaction, based on any such information or recommendations, in accordance with the relevant provisions of this Title.

Article 24: Transactions executed with eligible counterparties

1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1) in respect of those transactions or in respect of any ancillary service directly related to those transactions.

2. Member States shall recognise as eligible counterparties for the purposes of this Article 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 this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations.

   Classification as an ECP under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 19, 21 and 22.

3. Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.

Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an ECP. Member States shall allow the investment firm to obtain this confirmation either in the form of a general agreement or in respect of each individual transaction.

4. Member States may recognise as eligible counterparties third country entities equivalent to those categories of entities mentioned in paragraph 2.

Member States may also recognise as eligible counterparties third country undertakings such as those mentioned in paragraph 3 on the same conditions and subject to the same requirements as those laid down at paragraph 3.

5. In order to ensure the uniform application of paragraphs 2, 3 and 4 in the light of changing market practice and to facilitate the effective operation of the single market, the Commission may adopt, in accordance with the procedure referred to in Article 64(2), implementing measures which define:

(a) the procedures for requesting treatment as clients under paragraph 2;

(b) the procedures for obtaining the express confirmation from prospective counterparties under paragraph 3;

(c) the predetermined proportionate requirements, including quantitative thresholds that would allow an undertaking to be considered as an ECP under paragraph 3.

Annex II: Professional Clients for the Purpose of this Directive

Professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In order to be considered a professional client, the client must comply with the following criteria:

I. Categories of client who are considered to be professionals

The following should all be regarded as professionals in all investment services and activities and financial instruments for the purposes of the Directive.

(1) Entities which 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:

(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: EUR 20 000 000,
- net turnover: EUR 40 000 000,
- own funds: EUR 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 IMF, the ECB, the EIB 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.

The entities mentioned above are considered to be professionals. They must however be allowed to request non-professional treatment and investment firms may agree to provide a higher level of protection. Where the client of an investment firm is an undertaking referred to above, the investment firm must inform it prior to any provision of services that, on the basis of the information available to the firm, the client is deemed to be a professional client, and will be treated as such unless the firm and the client agree otherwise. The firm must also inform the customer that he can request a variation of the terms of the agreement in order to secure a higher degree of protection.

It is the responsibility of the client, considered to be a professional client, to ask for a higher level of protection when it deems it is unable to properly assess or manage the risks involved.

This higher level of protection will be provided when a client who is considered to be a professional enters into a written agreement with the investment firm to the effect that it shall not be treated as a professional for the purposes of the applicable conduct of business regime. Such agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction.

II. Clients who may be treated as professionals on request

II.1. Identification criteria

Clients other than those mentioned in section I, including public sector bodies and private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules.

Investment firms should therefore be allowed to treat any of the above clients as professionals provided the relevant criteria and procedure mentioned below are fulfilled. These clients should not, however, be presumed to possess market knowledge and experience comparable to that of the categories listed in section I.

Any such waiver of the protection afforded by the standard conduct of business regime shall be considered valid only if an adequate assessment of the expertise, experience and knowledge of the client, undertaken by the investment firm, gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved.

The fitness test applied to managers and directors of entities licensed under Directives in the financial field could be regarded as an example of the assessment of expertise and knowledge. In the case of small entities, the person subject to the above assessment should be the person authorised to carry out transactions on behalf of the entity. In the course of the above assessment, as a minimum, two of the following criteria should be satisfied:

- 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,
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 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.

II.2. Procedure

The clients defined above may waive the benefit of the detailed rules of conduct 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.

Before deciding to accept any request for waiver, investment firms must be required to take all reasonable steps to ensure that the client requesting to be treated as a professional client meets the relevant requirements stated in Section II.1 above.

However, 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 by any new rules adopted pursuant to this Annex.

Firms must implement appropriate written internal policies and procedures to categorise clients. Professional clients are responsible for keeping the firm informed about any change, which could affect their current categorisation. Should the investment firm become aware however that the client no longer fulfils the initial conditions, which made him eligible for a professional treatment; the investment firm must take appropriate action.

Article 71(6): Transitional provisions

Investment firms shall be authorised to continue considering existing professional clients as such provided that this categorisation has been granted by the investment firm on the basis of an adequate assessment of the expertise, experience and knowledge of the client which gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understands the risks involved. Those investment firms shall inform their clients about the conditions established in the Directive for the categorisation of clients.

MiFID Level 2: Draft Implementing Directive

(Draft Commission Directive Implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms, and defined terms for the purposes of that Directive)

Recital 69

Dealing on own account with clients by an investment firm should be considered as the execution of client orders, and therefore subject to the requirements under Directive 2004/39/EC and this Directive and, in particular, those obligations in relation to best execution. However, if an investment firm provides a quote to a client and that quote would meet the investment firm's obligations under Article 21(1) of Directive 2004/39/EC if the firm executed that quote at the time the quote was provided, then the firm will meet those same obligations if it executes its quote after the client accepts it, provided that, taking into account the changing market conditions and the time elapsed between the offer and acceptance of the quote, the quote is not manifestly out of date.

Article 28: Information concerning client categorisation

1. Member States shall ensure that investment firms notify new clients, and existing clients that the investment firm has newly categorised as required by Directive 2004/39/EC, of their categorisation as a retail client, a professional client or an ECP in accordance with that Directive.

2. Member States shall ensure that investment firms inform clients in a durable medium about any right that client has to request a different categorisation and about any limitations to the level of client protection that it would entail.

3. Member States shall permit investment firms, either on their own initiative or at the request of the client concerned:

   (a) to treat as a professional or retail client a client that might otherwise be classified as an ECP pursuant to Article 24(2) of Directive 2004/39/EC;

   (b) to treat as a retail client a client that is considered as a professional client pursuant to Section I of Annex II to Directive 2004/39/EC.

Article 50: Eligible counterparties

1. Member States may recognise an undertaking as an ECP if that undertaking falls within a category of clients who are to be considered professional clients in accordance with paragraphs 1, 2 and 3 of Section I of Annex II to Directive 2004/39/EC, excluding any category which is explicitly mentioned in Article 24(2) of that Directive.

   On request, Member States may also recognise as eligible counterparties undertakings which fall within a category of clients who are to be considered professional clients in accordance with Section II of Annex II to Directive 2004/39/EC. In such cases, however, the undertaking concerned shall be recognised as an ECP only in respect of the services or transactions for which it could be treated as a professional client.

2. Where, pursuant to the second subparagraph of Article 24(2) of Directive 2004/39/EC, an ECP requests treatment as a client whose business with an investment firm is subject to Articles 19, 21 and 22 of that Directive, but does not expressly request treatment as a retail client, and the investment firm agrees to that request, the firm shall treat that ECP as a professional client.

   However, where that ECP expressly requests treatment as a retail client, the provisions in respect of requests of non-professional treatment specified in the second, third and fourth sub-paragraphs of Section I of Annex II to Directive 2004/39/EC shall apply.

Annex 3

MiFID client categorisation notification obligations

MiFID Provisions				
Client type	**MiFID**		**Draft Implementing Directive**	
	Article 24	**Annex II**	**Article 28**	**Article 50**
Retail			*Notification* • Firm must notify client of categorisation as a retail client • Firm must inform client about any right to request a different categorisation and the consequent limitations to the level of client protection *Procedure* • Information on the right to request a different categorisation and the consequent limitations to the level of client protection must be provided in a durable medium • Art. 2(2) of Implementing Directive defines 'durable medium' • Art. 3 of Implementing Directive further specifies conditions for the provision of information in a durable medium	
Per se professional requesting treatment as a retail client		*Notification* • Where a per se professional client requests a higher level of protection, it must notify the firm that it should not be treated as a professional for the conduct of business regime (Annex II.I) *Procedure* • Notification must be provided in a written agreement between the client and firm • The agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction		

Note: This table is intended as general information and sets out the views contained in this paper. It is not intended to be either exhaustive or conclusive. Reference should be made to any subsequent amendments made during the consultation process.

MiFID Provisions				
Client type	**MiFID**		**Draft Implementing Directive**	
	Article 24	**Annex II**	**Article 28**	**Article 50**
ECP requesting treatment as a retail client	*Notification* • An ECP can request, either on a general form or on a trade by trade basis, treatment as client whose business with the investment firm is subject to Articles 19, 21 and 22	*Procedure* • Notification must be provided in a written agreement between the client and firm • The agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction (Annex II.I)		*Notification* • An ECP who wishes to be treated as a retail client must expressly request such treatment *Procedure* • The provisions in respect of non-professional treatment specified in the second, third and fourth paragraphs of MiFID Annex II.I shall apply
Per se professional		*Notification* • Firm must inform per se client prior to service that: – on basis of information available, the client is deemed to be professional, and will be treated as such unless otherwise agreed (Annex II.I) – the per se professional client can request a variation of the terms of the agreement in order to secure a higher degree of protection	*Notification* • Firm must notify client of categorisation as a professional client • Firm must inform client about any right to request a different categorisation and the consequent limitations to the level of client protection *Procedure* • Information on the right to request a different categorisation and the consequent limitations to the level of client protection must be provided in a durable medium • Art. 2(2) of Implementing Directive defines 'durable medium' • Art. 3 of Implementing Directive further specifies conditions for the provision of information in a durable medium	
Elective professional		*Notification* • The client must notify the 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 • Firm must notify client of the protections and investor compensation rights they may lose • Client must notify firm that they are aware of losing such protections (Annex II, II.2) *Procedure* • All notifications must be made in writing with the client's loss of protection notification also in a separate document from the contract	*Notification* • Firm must notify client of categorisation as a professional client • Firm must inform client about any right to request a different categorisation and the consequent limitations to the level of client protection *Procedure* • Information on the right to request a different categorisation and the consequent limitations to the level of client protection must be provided in a durable medium • Art. 2(2) of Implementing Directive defines 'durable medium' • Art. 3 of Implementing Directive further specifies conditions for the provision of information in a durable medium	

Note: This table is intended as general information and sets out the views contained in this paper. It is not intended to be either exhaustive or conclusive. Reference should be made to any subsequent amendments made during the consultation process.

MiFID Provisions				
Client type	**MiFID**		**Draft Implementing Directive**	
	Article 24	**Annex II**	**Article 28**	**Article 50**
ECP requesting treatment as a professional client	*Notification* • An ECP can request, either on a general form or on a trade by trade basis, treatment as a client whose business with the investment firm is subject to Articles 19, 21 and 22			*Notification* • An ECP may request treatment as a client whose business with an investment firm is subject to Articles 19, 21 and 22, without expressly requesting treatment as a retail client *Procedure* • If the investment firm agrees to the request, the firm shall treat the ECP as a professional client
ECP			*Notification* • Firm must notify client of categorisation as an ECP • Firm must inform client about any right to request a different categorisation and the consequent limitations to the level of client protection *Procedure* • Information on the right to request a different categorisation and the consequent limitations to the level of client protection must be provided in a durable medium • Art. 2(2) of Implementing Directive defines 'durable medium' • Art. 3 of Implementing Directive further specifies conditions for the provision of information in a durable medium	
Clients requesting treatment as an ECP	*Notification* • Firm must obtain express confirmation that client agrees to be treated as ECP (Art. 24(3)) *Procedure* • Confirmation can be in a general agreement or on a transaction by transaction basis (Art. 24(3))			

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Annex 4

COB/MiFID 'map'

CLIENT CLASSIFICATION (COB)		CLIENT CATEGORISATION (MiFID)	
Private Customer		**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 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	→	Possible 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	

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CLIENT CLASSIFICATION (COB)		CLIENT CATEGORISATION (MiFID)	
Intermediate Customer		**Retail Client**	**Per se Professional Client**
Local Authority	→		No change. Regional Government.
Public Authority	→	Possible change Becomes retail client unless:	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	→		No change. 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	
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.

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CLIENT CLASSIFICATION (COB)		CLIENT CATEGORISATION (MiFID)	
Market Counterparty		***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.	No change for Art 24(1) Business. 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 of 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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74 Article 24 allows UCITS and their management companies to be recognised at eligible counterparties unless entity is a financial institution authorised or regulated by Community Law.

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