



MiFID: customer classification, suitability and appropriateness

The changes made by MiFID to the current FSA client classification system will have significant practical implications for firms, particularly in the application of FSA conduct of business rules. Suitability and appropriateness are two of the key areas of the MiFID conduct of business regime, meaning firms will be subject to new and/or additional requirements in the areas of portfolio management, investment advice and execution-only business. This briefing summarises the key issues arising from the current position.

Introduction

The Markets in Financial Instruments Directive (MiFID) will make a number of changes to the current Financial Services Authority (FSA) client classification system that will have significant practical implications for firms, in particular in terms of the application of FSA conduct of business rules. Suitability and appropriateness are two of the key areas of the MiFID conduct of business regime, which will result in firms being subject to new and/or additional requirements in the areas of portfolio management, investment advice and execution-only business.

The client classification and conduct of business requirements are contained in various provisions of MiFID and in the draft level 2 directive published by the European Commission in February 2006. The FSA is due to publish a discussion paper on these requirements in the third quarter of 2006.

This briefing summarises the key issues arising from the current position (this is based on the draft level 2 Directive and is therefore liable to change).

Client classification: overview

There are three categories of client under MiFID: (i) eligible counterparties; (ii) professional clients; and (iii) retail clients. As with the UK regime, greatest regulatory protection is extended to retail clients with more limited rules applying in relation to dealings with professionals and eligible counterparties.

The eligible counterparty category is split into the following:

- *Per se* eligible counterparties (ie entities automatically treated as eligible counterparties) such as investment firms, credit institutions, insurance companies, undertakings for the collective investment of transferable securities (UCITS), pension funds and national governments.
- Entities that may be treated as eligible counterparties with their consent such as large undertakings (that meet specified size tests) and clients who may be treated as professional clients in accordance with the prescribed opt up criteria. Member state recognition is required for such entities to be treated as eligible counterparties. MiFID provides that a counterparty's status is to be determined by the rules of the member state in which it is established. This could lead to inconsistency across the EU with the same entity qualifying for different categorisations in different member states.

The definition of 'professional client' includes all of the entities that fall within the eligible counterparty category plus a handful of others (such as 'institutional investors whose main activity is to invest in financial instruments'). Additionally, retail clients may be treated as professionals on request.

Any clients not falling within these categories (such as private individuals) will be retail clients.

Clients may, either on the initiative of an investment firm or at the client's request and with the consent of the firm, be opted down to a more protective client classification.

Client classification: key changes and practical impact

The MiFID client classification system differs from the current FSA regime in a number of key respects.

- Unlike the current system, the MiFID client categories are not mutually exclusive – eligible counterparties are, in effect, a subset of professional clients. Eligible counterparty status is relevant only for certain types of investment business, broadly, dealing and arranging deals in investments. It is not relevant to, for example, portfolio management or investment advice. This means that the same client will have different classifications depending on the type of business the firm is carrying on.
- Although the scope of the MiFID client categories is similar to that of the corresponding FSA categories, there are a number of differences of detail that will require firms to reclassify certain clients (this may need to be done at implementation of MiFID, as there will be only limited scope for grandfathering). In particular, some clients who are currently classified as intermediate clients will be retail clients under MiFID. Firms that deal only with professional clients will need to decide whether to retain such clients (with the additional regulatory and systems burden this will involve). In some cases it may be possible to opt clients up to professional status (see below).
- The treatment of entities that are acting as agents for third parties (eg investment managers) is not prescribed by MiFID and the FSA therefore appears to have scope to preserve the existing position on this (under which the agent will generally be treated as the client).
- Opting clients up or down between different categories is generally possible under MiFID, subject to compliance with certain specified criteria and procedures. However, the criteria and procedures for opting retail clients up to professional client status are more onerous than those governing opt ups from private to intermediate client status under current FSA rules. In particular, the firm may opt a client up only if it has assessed the client's expertise and knowledge and is satisfied that the client is capable of making its own investment decisions and understanding the risks involved regarding the types of transactions and services envisaged. During this assessment, the firm must be satisfied that at least two of the following criteria are satisfied:

- the client must have 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 securities portfolio (including cash deposits and financial instruments) exceeds €500,000;
 - the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
- MiFID classifies investment managers as eligible counterparties. However, it is likely that many will request opt downs, in particular to avoid a mismatch between duties (such as best execution) they will owe to their clients and the duties they are owed by firms they deal with.
 - Clients may request opt ups in respect of particular services or transactions, as well as generally, potentially giving rise to additional complexity for firms.

Suitability and appropriateness

The suitability obligation is owed wherever a firm provides investment advice or portfolio management services to a client. The firm must obtain sufficient information regarding the client's knowledge and experience, financial situation and investment objectives to enable it to recommend investment services and financial instruments suited to the client.

A key difference from the current regime is that the suitability duty is owed not only to retail clients but also to professional clients, including eligible counterparties. However, the practical effect of this is limited by the draft level 2 directive, which allows firms to assume that a professional client has the necessary experience and knowledge (ie it only needs to consider the client's financial situation and investment objectives).

Additionally, where a firm is providing investment advice to a professional client (other than one that has been opted up from retail status) it can also assume that the client is financially able to bear the risk of any loss the investment may cause.

The appropriateness test is a new requirement in the UK context and will apply whenever a firm provides services

to a client, whether professional (but not eligible counterparties) or retail – other than investment advice or portfolio management. In particular, it will apply to the provision of execution-only services. The firm must request information from the client regarding his knowledge and experience to enable the firm to assess whether the service or product is appropriate for the client.

The application of the appropriateness requirement is, in practice, limited in a number of respects:

- As with the suitability obligation, the draft level 2 directive permits firms to assume that professional clients have the necessary experience and knowledge (as indicated above, the requirement will not apply at all where a firm is providing execution-only services to eligible counterparties).
- In relation to retail clients, firms may be able to rely on the exemption for execution-only services in article 19(6) of MiFID. This is available where: i) the services relate to shares admitted to trading on a regulated market, bonds or other forms of securitised debt, UCITS and other non-complex financial instruments; ii) the service is provided at the initiative of the client; iii) the client has been warned that it will not have the benefit of any suitability assessment by the firm; and iv) the firm complies with its obligations under MiFID regarding conflicts of interest. Article 39 of the draft level 2 directive specifies various criteria for non-complex instruments. These provide (among other things) that all derivatives will not be viewed as non-complex; execution-only trading in derivatives with retail clients will therefore be subject to an appropriateness test.

Next steps

Firms should:

- carry out an initial assessment of the extent of client reclassifications (including opt ups/opt downs) required within different business areas and the impact on the firm's business model in each of these areas (considering, in particular, the type of clients they are prepared to deal with); and
- consider the application of the modified conduct of business requirements to their business.

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