

**Bond Market Association  
International Capital Market Association  
International Swaps and Derivatives Association  
London Investment Banking Association**

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**Comments by BMA, ICMA, ISDA AND LIBA on FSA's August 2006 Informal Discussion Paper on "Implementing MIFID's Client Categorisation requirements"**

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Overall, much of the paper is very helpful, in particular the transitional arrangements proposed for classifying existing clients and reviewing client classification. We welcome FSA's commitment to a pragmatic and proportionate approach to ensure minimal disruption to existing relationships and business models. It is in that context that we make many of the detailed comments below, and we would like to draw attention in particular to the following key points:

- i. The existence of minimum quantitative criteria for clients to be treated as professionals or eligible counterparties should not prevent firms from being able to treat clients as professionals or eligible counterparties on the basis of a qualitative assessment of expertise, experience, and knowledge when the nature of the service provided makes the minimum quantitative criteria irrelevant (paragraph 5 below).
- ii. FSA should enable professional clients listed in paragraph 4 of Annex II.1 of MIFID to choose counterparty status under MIFID Level 2 Article 50.1, second paragraph, even though they do not fall within Annex II.II of the Level 1 Directive (paragraph 9 below).
- iii. We welcome several aspects of FSA's analysis in Chapter 4 of the distinction between investment services and investment activities. The clarification in paragraph 4.5 that dealing on own account could be a pure investment activity, and the criteria in paragraph 4.4, which focus on contractual or agency obligations, are helpful. However, we are concerned that some other aspects of paragraph 4.4 (as explained in detail in paragraphs 22 to 25 below), unless linked to the others, could as stated extend the scope of investment services, and the application of best execution obligations, beyond where a firm owes contractual or agency obligations, and therefore undermine the distinctiveness of 'investment activities', and need to be modified or interpreted so that they do not do so. In particular:
  - The second criterion in paragraph 4.4 is too broad, and therefore does not on its own help to clarify the scope of 'investment services'. FSA should make clear that the second criterion is limited by the first, third, fifth and sixth. It would be helpful if FSA would also make clear that a firm can provide services to a client for some purposes and not for others.

- In the case of the third criterion, an agreement that there is no client relationship should be conclusive in the case of professional clients, who by definition have the knowledge and expertise to determine whether or not they wish to transact on a service basis.
- It is important that the fourth criterion is not taken as implying that a dealer would need to deal exclusively with eligible counterparties to avoid owing best execution obligations. Since the third criterion covers the expectations of the parties, we suggest that FSA should delete the fourth criterion.

We urge FSA to ensure that the interpretation as a whole is consistent with MIFID Level 1 Recital 33, and that it is reflected in its interpretation of ‘client order’, along the lines which we set out in our response to DP06/3 (paragraphs 19 to 25 below).

- iv. It will be important to explore the scope for interpreting the large undertaking thresholds flexibly so that members of large groups that happen on an individual company basis to fall below the size requirements are not prevented from being treated as professional clients (paragraph 31 below).

### Detailed comments

#### Chapter 2

1. It would be helpful if FSA confirmed how the quantitative tests for “large undertakings” apply to entities such as trusts. While trusts may not have “turnover” as such, it seems to us that the concept of “own funds” can be applied as if it referred to net assets. It will be important as far as possible to enable trusts which are currently intermediate customers to map across into the professional category.
2. Paragraph 2.12. Footnote 19 is a helpful clarification of the meaning of bringing about or entering into transactions, and that the ECP regime embraces corporate finance advice as an ancillary service. In the latter context, it is important all aspects of corporate finance advice are embraced within ancillary services.
3. Paragraph 2.14. We welcome the helpful clarification of flexibility to agree selective obligations for ECPs. FSA should confirm that the resulting obligations are contractual in nature (not regulatory obligations arising under FSA rules).
4. Paragraph 2.16. We agree that firms have the choice whether to provide services to a client on the basis of a different categorisation that a client requests.
5. Paragraphs 2.20 and 2.21. The quantitative criteria are based on a model of clients that enter into transactions and hold portfolios of financial instruments. FSA should adopt a purposive approach to the application of these quantitative criteria to services of a type to which the frequency of transactions and size of portfolio are not relevant, for example corporate finance. In cases where the

minimum criteria are irrelevant because of the nature of the service, firms should simply be required to make a qualitative assessment of the expertise, experience, and knowledge of the client. (Cf FAQ10)

6. FSA should clarify when charities are "undertakings" and thus can qualify as large undertakings. The definition in section 259 Companies Act 1985 is helpful in so far as it indicates that incorporated charities are to be regarded as undertakings. It also suggests that a partnership or an unincorporated association is an undertaking if it carries on a trade or business, with or without a view to profit.
7. Paragraph 2.21. It would be helpful if FSA could clarify that it would be reasonable to interpret 'working in the financial sector' as including working in the relevant department of a corporate which was involved in the financial sector, even though the financial sector might not be the corporate's primary business.
8. We welcome FSA's proposal in paragraph 2.26 to take full advantage of the Directive's discretions to give clients the maximum flexibility to be treated as ECPs. FSA should apply the same approach to elective ECPs as to elective professionals in cases where the quantitative criteria are not applicable, as described in paragraph 5 above.
9. Furthermore, in order to give clients maximum flexibility, FSA should also enable those professional clients listed in paragraph 4 of Section I of Annex II of MIFID to choose eligible counterparty status under MIFID Level 2 Article 50.1, second paragraph. We consider that, in this context, the cross-reference in the second paragraph of article 50.1 to clients who are considered to be professional clients "in accordance with Section II of Annex II" MIFID, should be read as also covering persons falling within paragraph 4 of Section I of Annex II who could be treated as professionals in accordance with that section if it applied to them. It would create an unacceptable anomaly if, for example, firms could not treat smaller hedge funds as ECPs.
10. In any event, the answer to FAQ 21 should be amended to bring it into line with paragraph 2.25 and Footnote 27 by referring to the possibility, under the second paragraph of Level 2 Directive Article 50.1, for elective professionals to choose ECP status.
11. We welcome the flexibility of interpretation of quantitative thresholds that FSA points towards in paragraph 2.34, but we think that there should be much more latitude for clients to drop below thresholds for longer than one day without losing their elective status.
12. We agree with FSA's initial preference in paragraph 2.43 for the third option under paragraph 2.38. It is very important in this context to maximise the extent of grandfathering of existing classifications.
13. We support the approach to client classification for non-MIFID business that FSA proposes in paragraph 2.47, to use MIFID nomenclature but modify the

criteria, such as the disapplication of quantitative tests for opting up to professional status. However, FSA should also provide for disapplication of quantitative tests for MIFID business as described in paragraph 5 above.

14. It would be helpful to have a discussion of the treatment of client classification issues in relation to branches of EEA firms in other EEA states. There are a number of practical issues which are of considerable importance, bearing in mind that the operations in the branch will be subject to home state rules for some purposes where client classification matters (e.g. in relation to client assets or any services the branch may provide which are not provided “within” the branch state) but subject to the branch state rules for other purposes (e.g. in relation to services provided within the branch state). If the home state rules are to apply for client classification purposes, it may be necessary or desirable for the home state to be able to “grandfather” classifications as a professional made in accordance with the rules of the branch state. It will also be necessary to address the treatment of eligible counterparties in the branch state under article 24.3 MiFID.

### Chapter 3

15. We welcome FSA’s proposal in paragraph 3.10 to permit firms to make use of the transitional grandfathering provision in the penultimate paragraph of Annex II.II.2 to enable existing expert private customers to be categorised as professional clients under MIFID.
16. We urge FSA to enable firms to make use of the transitional grandfathering provision in Level 1 Article 71.6, as described in paragraph 3.13. We very much support FSA’s preliminary view as set out in footnote 48. Efficient use of transitional grandfathering provisions will be very important for the smooth and cost-effective transfer to the MIFID regime.
17. We think that FSA should enable firms to grandfather existing market counterparties as professional investors under Article 71.6. This confirmation will be important in relation to advice or portfolio management services, which fall outside MIFID Level 1 Article 24.1, for which clients will be professionals under MIFID, and in relation to any existing market counterparties who are not able to be treated as eligible counterparties under Article 24, for example because they do not meet size tests.
18. FSA should also enable firms to take account of the fact that a client has previously been treated as professional by another firm when assessing the expertise, experience, and knowledge of the client.

### Chapter 4

19. The analysis of the distinction between investment services and investment activities is in several respects a helpful clarification of how the best execution provisions might apply under MIFID (but see also paragraph 21 below). However, it is important to consider all of the criteria together, because in certain respects some of them on their own suggest an interpretation which

risks being both too broad and inconsistent with MIFID provisions on when best execution does or does not apply.

20. In particular, the clarification in paragraph 4.5 that dealing on own account could be a pure investment activity, and the criteria in paragraph 4.4 which focus on contractual and agency obligations, are helpful. However, other parts of paragraph 4.4, if taken on their own, could as stated extend best execution obligations beyond where a firm owes contractual or agency obligations, and need to be modified or interpreted so that they do not do so. These points are amplified in paragraphs 22 to 25 below. The discussion of the exclusion of eligible counterparties in paragraph 4.10 is also helpful, although it must not be interpreted as implying that eligible counterparty status is the only circumstance in which a firm does not owe best execution obligations.
21. FSA states in paragraph 4.14 that FSA will consider interpretative questions with respect to the definition of 'client order' "in the COB CP as part of our feedback on the [best execution] DP". Since this interpretation is crucial to determining the scope of best execution provisions and therefore the potential impact on firms' current business models and the scale of the system changes that firms may need to make, we urge FSA to build on paragraph 4.4 to confirm as early as possible an interpretation of 'client order' along the lines which we set out in our responses to DP06/3, and indicate whether this interpretation is shared by other EEA regulators.
22. Turning to the detail of paragraph 4.4, the first, third, fifth and sixth criteria are broadly consistent with MIFID Level 1 Recital 33: "[the best execution obligation] should apply to the firm which owes contractual or agency obligations to the client", and should therefore form the core of FSA's analysis (but see also our comments on the third criterion below). The second and fourth criteria should be limited by reference to the others.
23. The second criterion is too broad, and therefore does not on its own help to clarify the boundary between 'investment services' and 'investment activities' or reflect the ability of the parties under the third criterion to agree that they transact on an activities basis. Commercial relationships often involve 'some act or work for the other person' in circumstances where the firm is not acting in a contractual or agency capacity *on behalf of* the other person, which is a crucial element of MIFID Level 1 Article 4.1(5)'s definition of 'execution of orders on behalf of clients'. The criterion is so broad that it could mean that almost any act brings an 'investment activity' within the 'investment service' category. For example, two OTC dealers in shares could agree to a transaction to enable one or the other to make a portfolio adjustment. They will need to agree which of them will publish a trade report. They may from time to time take it in turns. We presume it is not FSA's intention that they should be clients of each other. FSA's examples cover a range of circumstances in which a firm does not necessarily owe a contractual or agency obligation to act on the other person's behalf. It is not the fact that a firm 'works' or 'customises' a transaction that should determine whether or not a firm provides a service and owes best execution, but whether or not it does so with an agency obligation or undertakes contractually to act on the client's behalf.

Almost any transaction, including many that do not involve an investment service but are clearly an investment activity, may involve providing a ‘facility to the other person such as the facilitation of transactions or providing an opportunity to trade’. FSA should therefore make clear that the second criterion is limited by the first, third, fifth, and sixth. It would be helpful if FSA would also make clear that a firm can provide services to a client for some purposes and not for others.

24. The third criterion is related to the first, and therefore an element of ‘contractual and agency obligations’. We agree that a statement that there is no client relationship should not be conclusive so far as retail clients are concerned (a matter which is dealt with in more detail in paragraphs 4.7 and 4.8). However, as FSA implies in Footnote 54, there is no reason why an agreement that there is no client relationship should not be conclusive in the case of professional clients, who by definition have the knowledge and expertise to determine whether or not they wish to transact on a service or activity basis. The section in brackets should therefore make clear that an agreement between the parties will be conclusive as regards professional clients.
25. It is important that the fourth criterion is not taken as implying that a dealer would need to deal exclusively with eligible counterparties to avoid owing best execution obligations. Given that FSA’s analysis seems to be aiming to determine whether a service is provided to entities which fall within defined categories of ‘professional client’ or ‘retail client’, the question of whether the investment firm has agreed to treat a person as a retail or professional client is not a limiting criterion. Since the third criterion covers the expectations of the parties, we suggest that FSA should delete the fourth criterion.
26. We welcome the implication in paragraph 4.9 that there will be no change in the existing exclusion from the definition of ‘client’ in the Glossary of corporate finance and venture capital contacts. It would be helpful if FSA could confirm that this is the case not only in relation to retail contracts, and that there is also no change in the exclusion from ‘clients’ of trust beneficiaries.

## Chapter 5

27. We strongly welcome FSA’s proposal in paragraph 5.7 to clarify, by retaining COB 4.1.5R, that MIFID Level 1 Article 20 relates solely to the question of whether a firm may rely on information provided by another firm, and does not affect the relationship between a firm and a client acting as agent. It would be helpful to have a discussion of how the provisos in COB4.1.5R work in the context of MIFID.
28. FSA should endorse the view that references to ‘investment firm’ in MIFID Level 1 Article 20 include any third country firm that satisfies the definition in MIFID Level 1 Article 4.1(1), even if it is not subject to MIFID. MIFID Level 1 Article 3 implies that where the Directive means to refer to investment firms authorised under MIFID, it says so (see also, for example, Recast CAD Article

3.1(b)). The reference to ‘investment firms’ in Article 20 should therefore be interpreted to include firms that satisfy the definition in Article 4.1, but which are exempted under Articles 2 or 3. It follows that Footnote 65 is incorrect and paragraph 5.12 is probably incorrect also.

## Chapter 6

29. Although, as FSA states in paragraph 6.4, there is no provision under MIFID for professional clients to agree that best execution will not be provided, FSA should give full weight to firms’ ability to follow specific client instructions.
30. Under paragraphs 6.5, 6.6, 6.7, and 6.8, FSA should apply COB provisions proportionately to professional clients. FSA's guidance should make clear that the result of Article 36 of the level 2 Directive is that firms are entitled to assume that professional clients have met appropriateness requirements for dealings in relation to which the client is classified as professional.

## FAQs

31. In FAQ4 FSA states, following the reference to ‘on a company basis’ in Annex II.I(2), that ‘the quantitative test for large undertakings is on a company basis, rather than on a group basis as currently under COB’. This would be a significant change, and raises issues such as the following:
  - for subsidiaries of large groups firms rarely see individual company financial statements, but rely on the group accounts; and
  - for parent companies of groups again firms tend to look at the group consolidated financial statements rather than the company-only ones. The consolidated statements are a truer statement of the size of the undertaking than the holding company’s.

FSA should as far as possible interpret Annex II.I(2) in a way that enables firms to take account of the size of the group to which a company belongs as well as the size of the specific legal entity. It will be important if possible to avoid for example the following:

- a small subsidiary of a very large group being treated as a retail client simply by virtue of the fact that the subsidiary’s own balance sheet and turnover figures do not exceed the thresholds;
  - a holding company of even a reasonably sized group (e.g. smaller listed ones) failing to meet the size thresholds for large undertakings, simply because the holding company itself has no or limited turnover and a small balance sheet total.
32. MIFID Level 1 Annex II provides an explicit arrangement under which a person can waive protections. There is no basis for limiting this by reference to the Level 1 Article 19(1) reference to the “best interests of the client”, as FAQ 8 implies. Limiting the ability to make such an invitation in this way

would significantly undermine the ability of firms to take advantage of the flexibility provided by the directive. Indeed, Article 19(1) imposes the duty to act in the interests of the client “when providing investment services and/or...ancillary services”: a firm is not actually providing services when inviting a client to elect for professional treatment. We note that there is no corresponding restriction in the current UK rules.

33. See our comments in paragraph 10 above on FAQ21.
34. It would be helpful if FSA could confirm that the necessary express confirmation under FAQ23 would be deemed to be given if the relevant client started to trade with the firm, and that this would constitute an ‘active demonstration of consent’.

#### Annex D

35. It is important that FSA gives a broad interpretation to the scope of paragraph 4 of Section I of Annex II MiFID i.e. ‘other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financial transactions’. This category should cover a broad range of different types of entity, in addition to Special Purpose Vehicles. As indicated in FAQ6, it also includes for example private equity funds and other unregulated funds (to the extent not covered by other paragraphs of Section I - see below), as well as bid vehicles and finance subsidiaries. A broad interpretation is important to limit the impact on existing unregulated intermediate customers of the ‘large undertakings’ limits in paragraph 2.
36. There appears to be an error in the proposed mapping for a firm or overseas financial services institution under COB4.1.7R. Such entities will probably qualify as per se professional clients, and may be eligible counterparties, and not be retail clients.
37. It is very helpful that FSA intends to treat a collective investment scheme as professional if its manager is authorised, especially since some hedge funds will not be authorised schemes or meet the large undertakings definition. However, it would be unhelpful if FSA took the narrow approach of limiting this to cases where the authorised ‘manager’ is the ‘operator’ of the scheme (compare FSA’s FAQ in the draft perimeter guidance concerning entities referred to in MIFID Level 1 Article 2.1(h)). In many cases, hedge fund managers will not be the operator of the scheme in this sense yet a firm ought to be able to treat the fund as professional if dealing with an authorised hedge fund manager even if (for other reasons) it is treating the underlying fund as a retail client. This will be particularly important unless FSA enables entities within paragraph 4, Section I Annex II to elect to be treated as ECPs.
38. FSA should indicate the circumstances in which pension funds will be treated as regulated in a manner bringing them within paragraph 1 Section I Annex II.