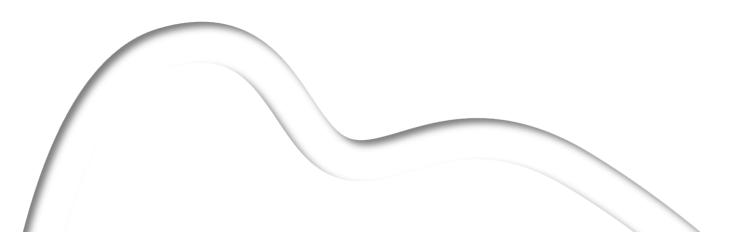


Guidance Note

Client Categorisation

Markets in Financial Instruments Directive [MiFID]

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Financial Services Commission PO Box 940, Suite 943, Europort, Gibraltar Tel (+350) 40283 Fax (+350) 40282 E-Mail: info@fsc.gi www.fsc.gi



1 Introduction

The Markets in Financial Instruments Directive (MiFID) came into effect on 01 November 2007, when it replaced the Investment Services Directive (ISD). MiFID has been implemented in Gibraltar via the Financial Services (Markets in Financial Instruments) Act 2006 ("the Act") and the Financial Services (Markets in Financial Instruments) Regulations 2007 ("the Regulations").

The aim of this Guidance Note is to supplement the legislation in regard to Client Categorisation.

1.1 Client Categorisation

MiFID recognises that investors have different levels of knowledge, skill, and expertise. The application of specific regulatory obligations under MiFID depends on a client's 'regulatory' category.

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).

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.

New client categorisation applies to any business that falls within MiFID and irrespective of it being conducted solely in Gibraltar or cross-border.

2 What is a client?

The term 'client' for the purposes of MiFID is used for any person or legal entity to whom a firm provides, intends to provide or has provided:

- (a) a service in the course of carrying on a regulated activity; or
- (b) in the case of MiFID business or an ancillary service, is a "client" of that firm

The term also includes a potential client.

A person to whom a financial promotion or marketing communication is or is likely to be communicated, is a "client" of the firm that communicates or approves it.

If the firm provides services to a person that is acting as the trustee of a trust, that person will be the firm's client and not the underlying beneficiaries of the trust.

Where the relationship is with a body corporate, the client may be the ultimate owner or the nominee company. The client agreement (or other suitable document or communication) should set out who the client is i.e. whether it is the ultimate beneficial owner of the company (for example, in the case of an investment holding company), or the agent of that company (for example, the corporate directors, in the case of a managed company or the board and/or shareholders in the case of a trading company).



Criteria indicating that a 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 party;
 - where a firm processes a transaction that it enters into or brings about with another person; or
 - where a 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 parties);
- whether a 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.

Note that when a firm is only performing an investment activity without providing an investment service, it will have no client and other client protections will not apply.

3 Client Categories

3.1 Definition of a retail client

A retail client is a client who is neither a professional client nor an eligible counterparty.

3.2 Definition of a per se professional clients

According to the Act a professional client is deemed as a client who possesses the experience, knowledge and expertise to make their own investment decisions and is able to properly assess the risks incurred. A professional client is not covered by the Gibraltar Investor Compensation Scheme (GICS).

In order to be considered a professional client there is certain criteria that must be complied with. The following should be regarded as *per se* professional clients.

 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: whether 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:



- credit institutions
- investment firms
- other authorised or regulated financial institutions¹
- insurance companies
- collective investment schemes and management companies of such schemes
- pension funds and management companies of such schemes.
- commodity and commodity derivatives dealers
- locals
- other institutional investors
- Large undertakings (i.e. body corporates or partnerships; or incorporated associations carrying on a trade or business, with or without a view to profit) meeting two of the following size requirements on a company basis:

Balance sheet total: €20m Net turnover: €40m Own funds: €2m

- National and regional governments, public bodies that manage public debt, the Gibraltar Savings Bank, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.
- Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

3.3 'Elective' professional clients (opting-up)

Retail clients can request treatment as professional clients. These clients are referred to by MiFID as elective professional clients.

Clients other than those mentioned in Part 3.2 above, including public sector bodies and private individual investors, may also be allowed to waive some of the protections afforded by GICS. Investment firms should therefore be allowed to treat any of these clients as elective 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 Schedule 2 of the Act.

Any such waiver of the protection afforded by GICS 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. This needs to be suitably documented and appropriately evidenced.

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¹ Company Managers and Trustee Companies do not fall under this term for the purposes of MiFID. They would be deemed as retail clients unless they can prove otherwise and may opt-up to professional status in accordance with the requirements outlined.



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 this, a separate 'quantitative' test.

The qualitative assessment requires the firm to undertake an adequate assessment of the expertise, experience and knowledge of the client that 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 of understanding the risks involved.

In relation to MiFID business, at least two of the following quantitative 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.

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.

Therefore if a client wishes to be treated as a professional client the following procedure must be 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 GICS rights they might 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 accepting any 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 above.

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.

3.4 Eligible counterparties

An eligible counterparty (ECP) is a client that is either a *per se* ECP or an elective ECP. A client can only be an ECP in relation to ECP business.

ECP business is defined as the following services and activities carried on by a firm:

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- (a) dealing on own account, execution of orders on behalf of clients or reception and transmission of orders; or
- (b) any ancillary service directly related to a service or activity referred to above.

It should be noted that it is only when carrying out the activities referred to above with an ECP that a firm is released from the specified obligations deriving from the Sections 19, 21 and 22 of the Act. Accordingly a client cannot be an ECP for the purposes of portfolio management or investment advice.

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

ECPs can be any of the following:

- investment firms
- credit institutions
- insurance companies
- UCITS and management companies of such schemes
- pension funds and management companies of such funds
- other financial institutions authorised or regulated under Community legislation or the national law of a Member State
- undertakings exempted from the application of MiFID under Section 4 (j) and (k)
- national governments and their corresponding offices including public bodies that dealt with public debt
- central banks and supranational organisations.

Comparison with the list of per se professionals;

- Third country (i.e. non-EEA) equivalent entities are within the professional regime but inclusion under the ECP regime is a matter for decision by each member state. Gibraltar has recognised third country equivalents as being within the *per se* class as per Section 24(7) of the Act.
- ECPs per se include UCITS but not other collective investment schemes.
- ECPs *per se* include Section 4 (j) and (k) commodity and financial future exempted firms whilst the professional regime includes commodity and commodity derivatives dealers.
- Regional governments are not specifically mentioned as ECPS per se.
- Large undertakings meeting the size requirements for professionals are not ECPs *per se*.
- "Locals" are not ECPs per se.
- Other (unregulated) institutional investors are not ECPs per se.
- Insurance and mortgage intermediaries are excluded.

A firm may treat as a professional client or a retail client a client that might otherwise be categorised as a *per se* ECP.

If a per se ECP requests treatment as a client whose business with the firm is subject to conduct of business protections, but does not expressly request



treatment as a retail client and the firm agrees to that request, the firm must treat that ECP as a professional client.

3.5 Elective eligible counterparties (opting-up)

A firm may treat as an elective ECP if:

- (a) the client is an undertaking (i.e. body corporates or partnerships, or unincorporated association carrying on a trade or business, with or without a view to profit) and:
 - I. is a *per se* professional client except for a client that has that categorisation because it is an institutional investor; or
 - II. requests such categorisation and is an elective professional client, but only in respect of the services or transactions for which it could be treated as a professional client;
- (b) and the firm has, in relation to MiFID business, obtained express confirmation from the prospective counterparty that it agrees to be treated as an ECP.

A firm may obtain a prospective counterparty's confirmation that it agrees to be treated as an ECP either in the form of a general agreement or in respect of each individual transaction.

The right to request treatment as an ECP is limited to undertakings therefore natural persons acting outside of their trade, business or profession cannot be treated as ECPs under any circumstances.

In relation to other (unregulated) institutional investors, who could be treated as retail clients, it would be possible for them to become elective professionals if they met the appropriate criteria. As elective professionals they could then be opted-up to elective ECPs.

4 What to do if already considered a professional client?

The Act provides for transitional provisions. Investment firms shall be permitted to continue considering existing professional clients as such provided that this categorisation has been granted by the 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 Act for the categorisation of clients.

Grandfathering under Section 61(6) will remain valid until the 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.

Where existing customers are treated as professional clients even though they do not fall within the MiFID definition of professional client, firms are required to notify clients of their classification and its consequences.



Firms will need to review the status and types of business conducted with existing market counterparties, and for any non-dealing business, such clients will need to be treated as professional clients.

Where existing market counterparties fall within the list of entities capable of being treated as ECPs (on either a *per se* or an elective basis) there will be no need to notify them of their categorisation as ECPs.

5 What if a client wants to be considered as retail on request (opting-down)?

A firm may agree to a request from a *per se* professional or a *per se* ECP to be categorised as a retail client thereby granting them 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. The firm would need to ensure that it follows the relevant requirements including the notification and client agreement obligations.

Where per se ECPs and per se professionals are to be categorised as retail, the client must enter 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, to more types of product or transaction or to one or more rules.

MiFID is clear that the professional client (or ECP) is responsible for making this request when it is unable to properly assess or manage the risks involved.

The ways in which a client may be provided with additional protections under this section includes re-categorisation on:

- (a) a general basis;
- (b) a trade by trade basis;
- (c) in respect of one or more particular services or transactions; or
- (d) in respect of one or more types of product or transaction.

Clients can be granted treatment as a retail client pursuant to Section I of Schedule 2 of the Act.

Regulation 28(3) states that a firm can unilaterally decide to treat any or all of its clients as retail clients if it chooses to do business on that basis.

6 Flexibility of allowing different categorisations for a particular client

MiFID permits clients to be categorised differently for different products and/or transactions provided certain criteria are met.

Firms will need to decide whether their business model permits their clients to take full advantage of this flexibility. This will depend on the costs of implementing such a business model and the costs of doing business on this basis.

Firms have the choice of whether to accept a request from a client to move between categories for different products/transactions. If the firm does not



agree to such a request, the client will need to source services with the desired level of protection elsewhere.

7 Notification to clients – MiFID requirement

Investment firms must notify new clients of their categorisation as a retail client, a professional client or an eligible counterparty.

Prior to the provision of services the firm must inform that client:

- their categorisation;
- any right that client has to request to a different categorisation; and
- any limitations to the level of client protection that such a different categorisation would entail.

This notification must be made in a durable medium.

The FSC will expect a firm to notify existing clients of their categorisation under MiFID if these existing clients have <u>not</u> been previously notified by the firm of their categorisation. This may be in the form of a one-way notice. This applies to firms that decide to unilaterally classify all clients as "retail", when said clients have not been previously notified of their categorisation.

Where a firm intends to re-classify or re-categorise a client, the FSC will also expect that firm to notify its clients of any re-classification or re-categorisation. In this case, however, the firm will need to obtain written consent to the change from the client for this, prior to transacting any further business. A one-way notice from the firm to the client will therefore not suffice for these purposes.

8 Recordkeeping

A firm must keep a record of each notification and each agreement made when categorising its clients.

A record must be made in relation to:

- (a) The categorisation established for the client, including sufficient information to support that categorisation;
- (b) Evidence of dispatch to the client of any notice required to be made;
- (c) A copy of any agreement entered into with the client.

Records must be made at the time of categorisation and should be retained for five² years after the firm ceases to carry on business with or for that client.

Further information regarding recordkeeping is covered in the Record Keeping & Client Reporting guidance note.

² Firms should note that they may have obligations under other legislative provisions that require records to be kept for a longer period of time.



9 Gibraltar Investor Compensation Scheme (GICS)

GICS is Gibraltar's statutory compensation fund for consumers who lose money due to the default of an authorised investment firm. Those who are able to benefit from the protection offered by GICS are known as eligible claimants.

Definitions of clients under GICS are directly linked to the definitions under MiFID.

Further details of the scheme can be obtained on their website http://www.gics.gi/home.htm.