DFSA response to public comments on CP 97 – 'Proposed Changes to the Client Classification Regime'

Status of this document

The information in this "feedback" document does not cover detailed aspects of the client classification regime. It contains a high level discussion of the public comments the DFSA received on CP 97, and the DFSA's response to those comments. Therefore, the statements in the document should not be read as definitive statements or opinions relating to the relevant legislation. They do not also constitute legal advice or guidance in respect of the relevant legislation and should not be acted upon as such. Instead, reliance must be placed on the relevant COB Rules as published on the DFSA website. Appropriate legal advice in relation to the legislation should be sought where necessary.

Background

1. This paper explains how the DFSA has responded to the public comments it received on the proposed changes to the client classification regime, set out in Consultation Paper 97, titled 'Proposed Changes to the Client Classification Regime' ("CP97").

2. We published CP97 on 15 September 2014 for public comment for 30 days. In all, 22 sets of written comments were received (see Annex A for a list of commentators).[1] We also heard representations from interested parties.[2] These comments and representations greatly assisted the DFSA in developing and refining its proposals so that they meet the needs of market participants while also achieving good regulatory outcomes. We are very thankful to those who have contributed.

3. The new client classification regime, contained in the Conduct of Business Module (COB) chapter 2, will come into effect on 1 April 2015, with one exception. This relates to the increase of the asset test applicable to 'assessed' Professional Clients from $500,000 to $1 million, which will come into effect on 1 April 2016. The potential for such a deferral was noted in CP97; public comments supported allowing Authorised Firms in the Centre more time to adjust to an increase in the asset threshold.

4. Importantly, the new regime has no retrospective effect. As a result, client classifications of existing Clients, as well as Transactions and Client Agreements entered into with such Clients under the old client classification regime do not have to be unwound. The new regime contains transitional provisions to grandfather those classifications, transactions and agreements.

Terminology

5. In this paper (except where otherwise indicated):

   a) a capitalised term is a defined term in the DFSA Glossary (GLO) module;

[1] The list does not include those commentators who requested anonymity.

[2] The DFSA also consulted a range of stakeholders at an earlier stage, whose views contributed to the proposals in CP97.

b) a ‘draft’ or ‘proposed’ Rule means a proposed Rule under CP97;

c) a ‘Firm’ means an Authorised Firm;

d) the ‘new regime’ means the client classification regime in COB chapter 2 that comes in to effect on 1 April 2015, and on 1 April 2016 in relation to the increase in the asset threshold;

e) the ‘old regime’ means the client classification regime in COB chapter 2 prior to 1 April 2015; and

f) the ‘transitional provisions’ mean the provisions in COB section 2.6 of the new regime.

DFSA’s general approach to public comments

6. The Legislative Committee of the DFSA Board considered the public comments received, and weighed those against the purpose of client classification, which is to ensure that Clients are given a level of regulatory protection that is in line with the resources and expertise available to them to make informed decisions and protect their own interests.

7. Taking that purpose into account, we have tried to provide more flexibility within the regulatory regime as requested by Firms, but we have not been able to agree to all requests seeking further flexibility. Where considered appropriate, the new regime provides greater clarity and certainty relating to the operation of the client classification regime. The new regime remains well aligned with international best practice as far as applicable, whilst also being tailored to address the needs of the DIFC.

Public comments

8. In general, public comments supported the aim of the proposals in CP97 but sought further expansions and clarifications in some areas. We received a significant volume of comments covering many detailed aspects of the proposals. Some comments contradicted or overlapped with others, so we have not attempted to provide a line-by-line response to each comment.

9. Instead we have set out the DFSA response around the key themes that emerged from public comments, under the following headings:

a) client re-classification;

b) ‘deemed’ Professional Clients;

c) look-through arrangements;

d) family member joint accounts;

e) Market Counterparty procedures;

f) reliance on external client classifications;

g) provision of Group-based financial services;

h) transitional arrangements and the new asset threshold;

i) other minor changes; and

j) issues for future consideration.

Client re-classification

10. Concerns were raised around when, or whether, a Firm would face an obligation to re-classify an existing Professional Client under the CP97 proposals. Firms without Retail Endorsements feared that they might have either to turn away existing Professional Clients or to unwind existing Transactions if the Clients failed to meet the requirements in the new regime. Implicit in some comments was also a fear that all Firms would be expected to undertake a re-classification of all existing Professional Clients/Market Counterparties when the new regime comes into force. We have addressed these concerns by providing greater clarity and flexibility.

11. Under the new regime, there are three possible triggers for a re-classification of an existing Client. These are not all new and arise where:

a) an existing Professional Client wishes to opt-in as a Retail Client to obtain a higher level of protection – this right existed under the old regime and is retained in the new regime;[3]

b) the Firm becomes reasonably aware that the Client no longer fulfils the Professional Client criteria – this obligation existed under the old regime, although not stated as explicitly as under the new regime; and [4]

c) a new Financial Service or financial product that is not similar to those previously offered is provided to:

- an existing 'grandfathered' Client; or
- any other existing Client.

12. Triggers (a) and (b) above remain as they were under CP97. The two triggers in (c) are mainly new, and a slightly different approach is adopted in respect of each. The benefit of grandfathering applies in respect only of those Financial Services which were provided to an existing Client under the old regime. As a result, if a new Financial Service or financial product is offered to a grandfathered Client, the Firm cannot rely on the grandfathering provisions and must re-classify the Client under the new regime.[5] However, where an

[3] See COB Rule 2.3.3(3) of the old regime.
[4] See Guidance No. 1 under COB Rule 2.3.2 of the old regime.
[5] See COB Rule 2.6.2 and associated Guidance under the new regime.

existing Client is not a grandfathered Client, we have retained the same flexibility as under the old regime where a re-classification is considered not always necessary – unless the new service or product is not similar to those previously provided to that Client.

13. We took a number of steps to improve certainty and clarity.

    a) To make it abundantly clear that the new regime has no retrospective effect, the transitional provisions expressly provide that Firms do not, upon the new regime coming into force, need to re-classify existing Professional Clients or re-negotiate existing Client Agreements.[6]

    b) We have also included good practice in Guidance which a Firm may follow when it offers a new Financial Service or financial product to an existing Client.

'Deemed' Professional Clients

14. Public comments raised two main concerns:

    a) that 'deemed' Professional Clients should have a right to opt-in as Retail Clients (in the same way as proposed for 'service-based' and 'assessed' Professional Clients); and

    b) that some of the terms used to define Large Undertakings (a category of 'deemed' Professional Clients) needed further definition to provide clarity.

15. To address these concerns, we have:

    a) allowed 'deemed' Professional Clients the right to opt-in as Retail Clients. Consistent with the European Union (EU) regime, this gives 'deemed' Professional Clients the opportunity to consider whether, particularly in relation to any particular type of Financial Service or product (e.g. complex derivatives), they would need a higher level of regulatory protection;[7] and

    b) included definitions of the terms 'balance sheet', 'own funds' and 'called up capital', which are used in the criteria for Large Undertakings, mirroring the relevant definitions under international accounting standards.[8]

Look-through arrangements

16. The CP97 proposals contained significant expansions to the old regime to give Firms more flexibility to attribute to a Retail Client the professional status of an 'eligible look-through entity' (i.e. an entity with which the Client has an ownership, business or personal relationship such as being a Holding Company, joint venture partner or a Family Member).

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6 See the transitional provisions discussed in paragraphs 26 to 29 of this paper.

7 See Rule COB 2.3.3(1)(b) under the new regime. See also the transitional provisions which mirror similar Guidance.

8 See COB Rule 2.3.4(3) under the new regime.

However, Firms sought even more flexibility and, also, more clarification and guidance relating to eligible look-through entities.

17. Set out below are the key issues raised by public comments, and how the DFSA has responded to those issues.

a) The CP97 proposals allowed an Undertaking to be 'assessed' as a Professional Client only where either it could meet, or it had, an eligible look-through entity which could meet, the 'assessed' Professional Client criteria. This was an unintended restriction. The new regime includes within eligible look-through entities Persons which can meet the 'deemed' Professional Client criteria.[9]

b) The CP97 proposals did not allow an Undertaking to be classified as a Professional Client in reliance on a look-through entity with which it did not have any strong nexus based on ownership or control (such as a Holding Company or Subsidiary of the Undertaking). The suggestion was made that just being any member of the same Group as the Undertaking should suffice. We did not consider it appropriate to take this suggestion on board, as the strong nexus between the Undertaking and the look-through entity is essential for the attribution of the professional status of the look-through entity to the Undertaking. Under the EU regime only Holding Companies and Subsidiaries are eligible look-through entities.

c) There was a further suggestion that it was appropriate to include, as an eligible look-through entity, a guarantor of the Undertaking's obligations if the guarantor meets the 'deemed' or 'assessed' Professional Client criteria. Again, we did not think that it was appropriate to extend the categories of eligible look-through entities to include guarantors, as guarantees are often revocable at the instance of the guarantor, and we could not find any precedent that supported such an expansion.

d) Another suggestion was to extend the Market Counterparty (MC) treatment to an Undertaking which qualifies as a Professional Client in reliance on a look-through entity which is a 'deemed' Professional Client.

We did not think that it was appropriate to extend the potential MC status in <u>all</u> cases of 'assessed' Professional Clients who do so in reliance on an eligible look-through entity which is a 'deemed' Professional Client. This is because the MC status is generally specific to the 'deemed' Professional Client's ability to negotiate on an equal footing with another Firm, which ability is not necessarily attributable to another Undertaking, except where that Undertaking is a wholly owned Subsidiary of the look-through entity. The new regime caters to this situation.[10]

e) It was pointed out that, under the CP97 proposals, an Undertaking could inappropriately qualify as a Professional Client by relying on a look-through entity

[9] See COB Rule 2.3.8(2) under the new regime, which now includes a reference to 'deemed' Professional Clients in Rule 2.3.4(1).

[10] See COB Rule 2.3.9(1)(a)(ii) under the new regime.

which has as little as 10% control over the Undertaking. This was an unintended effect because the defined term Controller in the DFSA Rulebook, which has an ownership or control threshold of 10%, is only applicable to a Controller of an Authorised Person[11] (and not to a controller of an Undertaking which is a Client).

We have corrected this by providing that the reference to a 'controller' of an Undertaking, in that context, is to a natural person controller who has majority shares or control of the Undertaking.[12]

f) Another suggestion was that an Undertaking should be allowed to qualify as a Professional Client if it has an unrelated sponsor meeting the Professional Client criteria, and for this to be allowed either through a Rule or through a discretion allowed to Firms to assess the appropriateness of doing so.

We did not think it appropriate to grant a wide discretion to Firms as suggested, as it could lead to practices not within the letter or spirit of the client classification provisions. Creating a Rule would be difficult, as it is challenging to ascertain when exactly an Undertaking would need to rely on the professional status of a sponsor with which it no longer has a relationship (legal or reputational).

This means that, as under the old regime, a case-by-case analysis would be required for an Undertaking to be allowed to qualify as a Professional Client in reliance on an unrelated sponsor. Given that the new regime significantly expands the categories of eligible look-through entities (reflecting existing waivers/modifications granted by the DFSA), we are confident that Firms will no longer need to resort to the waiver/modification route frequently to address situations of this type.

Family member joint accounts

18. Public comments raised two main issues relating to Family Member joint accounts.

19. The first was the difficulty in ascertaining who a Family Member is for the purposes of the family member joint account provisions in CP97,[13] as that term used a definition in the DIFC Single Family Office Regulations. We have addressed this issue by directly incorporating into the new regime an appropriate stand-alone definition of the term Family Member.[14]

20. The second issue was that members of a family should be allowed to rely on the Professional Client status of the head of the family[15] not just for a joint account (as under the CP97 proposals) but for all their investment activities. We did not think it was

[11] See the GLO definition of a 'Controller' of an Authorised Person.
[12] See COB Rules 2.3.8(3)(b) and 2.3.5(2) under the new regime.
[13] See COB Rule 2.3.7(3) under the CP97 proposals.
[14] See the COB definition of the term 'Family Member'.
[15] Note COB Rule 2.3.7(3) allows an individual to rely on any family member (not just the head of the family) with whom he has a joint account, provided that family member meets the Professional Client criteria.

appropriate to make such an extension, as the commonality of economic interest that exists between Family Members in a joint account scenario does not necessarily exist in relation to individual investment activities of those Family Members.

Market Counterparty procedures

21. The main concern raised in relation to Market Counterparties (MCs) was that, under the CP97 proposals which retained the existing position, written confirmation from the Client would still be required from some 'deemed' Professional Clients before their classification as a MC, while, for others, absence of objection within the specified period would suffice.

22. We considered the existing distinction to be unwarranted, especially as 'deemed' Professional Clients, being the main category who can be classified as MCs, are mainly wholesale/institutional investors. Under the new regime, the procedure for classifying a 'deemed' Professional Client as a MC is simplified by removing the dual procedures. Instead, in all cases of 'deemed' Professional Clients, to classify them as a MC, a Firm is required to:

    a) give a written notification to the Client stating the Firm's intention to classify it as a MC;

    b) specify in that notification the Client's right to object to classification as a MC within a period specified in the notification; and

    c) allow the Firm to classify the Client as a MC in the absence of any objection received from the Client within the specified period.[16]

Reliance on external client classifications

23. Most commentators supported the proposals to allow a Firm to rely on a client classification made by its head office or another branch, or another member of its Group. However, some commentators suggested that Firms should be allowed to rely on a client classification made elsewhere without a gap analysis if the entity making the classification is doing so under a regulatory regime which is declared by the DFSA to be equivalent to the DFSA regime.

24. We did not accept this suggestion because the gap analysis required is specific to the Financial Services proposed to be provided to a Client. Therefore, it is the Firm which is best placed to undertake that analysis, not the DFSA. However, as the DFSA regime is substantially aligned with the UK regime (as a proxy for the EU regime), we believe that the process of gap analysis which a Firm needs to undertake when relying on client classification made under MiFID[17] by an EU-based head office or another branch, or a Group member, should be straightforward.

[16] See COB Rule 2.3.9(2) under the new regime.
[17] The Markets in Financial Instruments Directive.

Provision of Group-based financial services

25. The main concern raised in relation to Group-based financial services was uncertainty around what constitutes a 'bundle' of financial services. While we do not think it was appropriate to include a definition of a 'bundle of financial services' (as different Groups may use different arrangements to bundle their services), to provide greater clarity around this issue, we have included in Guidance information about the type of arrangements which the DFSA would consider as a bundle of financial services.[18]

Transitional arrangements and the new asset threshold

26. Many concerns were raised about the need for, and the exact scope of, the transitional arrangements that would be available to Firms under the new regime. The main concerns related to:

    a) whether Firms would lose existing Clients or have to unwind Transactions with Clients who do not meet the new Professional Client criteria; and

    b) how the increase of the asset threshold from $500,000 to $1 million in one year's time would impact on the Firm's existing Professional Clients.

27. The new regime is not intended to result in Firms having to lose their existing Professional Clients or having to unwind Transactions with them. This is because the new regime:

    a) has not removed any existing categories of Professional Clients, instead, has added new categories of Professional Clients (such as Large Undertakings, and 'service-based' Professional Clients); and

    b) does not have any automatic retrospective effect that would cause existing client classifications and Transactions to be invalidated upon the new regime coming into force.

    To remove any uncertainty, we have included, as foreshadowed in CP97, adequate transitional arrangements under the new regime to grandfather existing client classifications, Client Agreements and Transactions.[19]

28. While some commentators felt that the proposed increase in the asset threshold from $500,000 to $1 million may be too big an increase, others noted that their Clients already meet the proposed threshold and so would have minimal impact if any. Some commentators suggested that the proposed increase should be implemented over a period longer than one year, and introduced incrementally. Given the wide range of comments (both for and against the proposed increase) and our aim to ensure that the asset threshold remains appropriate for the DIFC, we concluded it was appropriate to retain our initial proposal under CP97. We also thought it appropriate, as was stated in

[18] See Guidance No. 1 and 2 under COB Rule 2.4.5 under the new regime.
[19] See COB Rules 2.6.1 and 2.6.2 under the new regime, and also paragraphs 11 to 13 for details relating to the scope of grandfathering provisions.

CP97, to have the increase come into force one year after the new regime comes into force (i.e. on 1 April 2016).[20]

29. As the increase to the asset threshold comes into force only on 1 April 2016, Firms can continue to use the $500,000 asset threshold to classify new Clients from now until that date. These Clients would then also have the benefit of being grandfathered.[21]

Other minor changes

30. We have also made minor changes to the draft Rules under CP97 to clarify matters, both through our own initiative and prompted by public comments. As they are not substantial, this paper does not document them.

Issues for future consideration

31. A few commentators noted that client classification may not be entirely appropriate in some circumstances, particularly for reinsurance related activities. While there is some merit to this argument, we thought it appropriate not to make any piece-meal changes to the current regime in this area. Instead, we expect to consider these issues in due course as part of a discrete project to review the regulatory regime applicable to insurance-related Financial Services.

32. A few commentators also suggested that Firms should be able to treat, as their Client, an agent (e.g. an individual holding a power of attorney from a principal), instead of the principal. Under the existing COB regime (in relation to which CP97 proposed no change)[22], the principal and not the agent is the Client of the Firm (unless the agent is another Authorised Firm). We intend to consider whether there are any circumstances in which a Firm may be able to demonstrate to us that there is a genuine need to treat the agent, and not the principal, as the Client of the Firm and, by doing so, the principal is not unduly deprived of the regulatory protection otherwise available to him as the Client of the Firm.

[20] See COB Rule 2.6.3(1) under the new regime.
[21] See COB Rule 2.6.3(2) under the new regime.
[22] See COB Rule 2.3.1(3) of the new regime which retains COB Rule 2.3.1(3) of the old regime, with minor changes.

Annex A
List of non – confidential commentators on CP97 proposals

1. Barclays
2. CCL Limited
3. CCL Limited (on behalf of) Compliance Officers Networking Group
4. Callidus Consulting
5. Now Health International Limited
6. Herbert Smith Freehills LLP
7. Standard Chartered Bank
8. Kotak Mahindra Financial Services Limited
9. Etive Consulting
10. Alpen Asset Advisors Limited
11. Union Bancaire Privee (Middle East)
12. IG Group
13. Julius Baer (Middle East) Ltd
14. State Bank of India
15. ICICI Bank Limited
16. DBS Bank Limited
17. International General Insurance Co. (Dubai) Ltd
18. The Bank of Tokyo Mitsubishi UFJ, Ltd
19. Natixis