Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Markets in Financial Instruments Directive II Implementation – Client Categorisation

Lead regulator: FCA

Date of assessment: 20 December 2017

Commencement date: 3 January 2018

Origin: Domestic extension of EU legislation

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of the UK

Brief outline of proposed new or amended regulatory activity

The Markets in Financial Instruments Directive (MiFID) regime (implemented in 2007) uses client 'categories' to recognise that investors have different levels of experience, knowledge and expertise. It tailors MIFID regulatory protections provided by investment firms to those investors accordingly. Under this regime, investors will either be retail clients, professional clients or eligible counterparties (ECPs)[1]. Investment firms must provide them with one of these categorisations at the start of the relationship and keep it under review. Investors will automatically be categorised upon meeting certain criteria (*per se* categorisation) or may ask to be treated as a more sophisticated client (resulting in less regulatory protection but potentially enabling access to a wider range of products or services) subject to meeting further criteria set out in regulation (*elective* categorisation). As well as providing tailored regulatory protection, it may also impact on the ability of investors to access more complex, risky investments.

The revised EU Markets in Financial Instruments Directive (2014/65/EU), known as MiFID II, was agreed and published in the official journal of the EU on 15 May 2014. While most of the client categorisation regime did not change between the MiFID and MiFID II regimes, MiFID II

[1] Broadly speaking, professional clients include per se professionals such as other authorised financial service firms or pension funds, large companies that exceed certain size thresholds, and national government or central bank bodies. The eligible counterparty classification is only relevant to certain types of activity – namely dealing on own account, executing orders, or receiving and transmitting orders – and is available to financial services firms, national governments and central banks, with other professional clients such as large corporates having the option to be 'elective' ECPs. Eligible counterparties are considered to act as equal parties and so are afforded limited protections. Retail clients are negatively defined as neither of the above, and are provided the greatest degree of protection, although they can elect up to professional client status if certain criteria are met, the client requests this in writing, the firm provides a written warning as to the protections they will lose, and this is acknowledged in writing by the client.

introduces new provisions which seek to increase regulatory protections for local or municipal public bodies. In implementing these rules we undertook several discretionary actions for which the administrative exclusion of implementing a European Directive would not apply.

1. Categorisation of ECPs

MiFID II client categorisation rules outline that only certain types of public body can be categorised as ECPs (e.g. those managing public debt at national level). It clarifies that elective professional clients will no longer be able to request treatment as ECPs and introduces new procedural requirements to be adhered to by firms when opting-up clients to become ECPs (including written confirmation and investor warnings).

For UK firms, we have decided to apply this same requirement to *non-MiFID business* that uses the MiFID-style client categorisation regime set out in the FCA Handbook.

2. Re-categorisation of local authority clients

MiFID II categorises local authorities as retail clients by default, with the ability to opt-up to professional client status (under MiFID, local authorities were *per se* professional clients).

On this element, MiFID II sets out harmonised rules around the process of opting up clients to professional client status, and carrying out a qualitative test of experience, knowledge and expertise. However, MiFID II also provides member states discretion to design appropriate additional quantitative criteria that local public authorities must meet before they can be opted up.

Following consultation, we decided in our final policy approach to use this discretion to require UK firms to ensure that local authority clients must meet the following quantitative tests:

- the size of the client's financial instrument portfolio defined as including cash deposits and financial instruments, exceeds £10,000,000 (the standard MiFID II requirement for this criteria is a portfolio size of €500,000, but was designed primarily for natural individuals);
  AND, either:
  - the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters; OR
  - the person authorised to carry out transactions on behalf of the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the provision of services envisaged; OR
  - the client is an 'administering authority' of the Local Government Pension Scheme within the meaning of the version of Schedule 3 of The Local Government Pension Scheme Regulations 2013 or, (in relation to Scotland) within the meaning of the version of Schedule 3 of The Local Government Pension Scheme (Scotland) Regulations 2014 in force at 1 January 2018, and is acting in that capacity (this is a bespoke criterion introduced by the FCA).

These criteria will apply to both MiFID and non-MiFID services that use the MiFID-style categorisations within the FCA rulebook. We also stipulated that firms should classify local authority treasury management activities separately from pension administration activities, given the very different nature of each. The same changes are also made in respect of the

application of the FCA Principles for Businesses, which also have tailored application for the three different client categorisations.[2]

Where a UK firm is serving a local authority based elsewhere in the EU, our final policy approach is that firms should defer to the quantitative criteria that are used by the national competent authority of the jurisdiction of the local authority. Where a local authority is based in a non-EU jurisdiction, we propose that the standard MiFID II quantitative criteria be used.

Which type of business will be affected? How many are estimated to be affected?

Firms (brokers, banks, investment managers) providing investment services to local authorities, for whom these rules will be applicable. There are estimated to be over 3,500 MiFID investment firms authorised in the UK. Although is not clear exactly how many of these serve local authorities, by calculating the number of local authorities which are likely to be impacted by our proposed rule changes, we have estimated that an upper range of 42 firms conducting MiFID business could be impacted by the changes.

To arrive at this number we utilised data from the Department of Communities and Local Government (DCLG). DCLG's 'E - code' definition of local authority identifies 518 local authorities.[3] Of these 518 local authorities with investments, we estimated that 324 have investments in MiFID scope instruments[4]. Of those 324 we estimate that 42 local authorities would not to be able to opt-up to professional client status in the financial year 2015/2016 as a result of the £10m cash and/or asset threshold (we assumed for this purpose they would be able to meet one of the other three required criteria).

Although there are many more firms undertaking non-MiFID business than MiFID business, it is likely only a very small number are providing those services for local authorities. As such we estimate that only 8 non-MiFID firms are likely to be impacted by our proposals, based on DCLG data on local authorities self-reported investments, and taking reported 'Other investments' as being equivalent to non-MiFID investments or investment services[5].

In a survey of FCA-authorised MiFID investment firms conducted in September 2015, less than 2% of respondents reported ever having the occasion to opt-up elective professional clients to ECP status. Firms also reported that, in general, they apply the same approach to ECPs across

---

[2] This primarily impacts Principle 7, which is only partially applied for ECPs, and Principles 6, 8 and 9, which only apply to retail or profession clients ('customers'), and not ECPs, since these principles imply a degree of reliance by the client on a firm that is not applicable in the context of two ECPs transacting with each other as sophisticated counterparties who are capable of protecting their own interests.

[3] 89 local authorities are members of the England and Wales Local Government Pension Scheme, and 11 local authorities are members of the Scottish Local Government Pension Scheme. There are estimated to be over 10,000 small town and parish councils that are theoretically impacted, although it is believed few, if any of these, are users of MiFID investment services.

[4] Department for Communities and Local Government, Statistical dataset, Live tables on local government finance, "Borrowing and Investment" table https://www.gov.uk/government/statistical-data-sets/live-tables-on-local-government-finance#borrowing-and-investment
The original, un-amended data for 2014-15 on borrowing and investment (the most current at the time of consultation) listed 518 local authorities in that year, plus the size of their various investments and borrowings. 324 had self-reported as having investments in: Treasury bills, Certificates of deposit at banks; Certificates of deposit at building societies; British Government (Gilt-edge) securities; Investments in Other financial intermediaries; Investments in Public corporations; Money market funds; and Externally managed funds. We used these categories to collectively represent investment in MiFID financial instruments, a term listed at section C of Annex 1 of Directive 2014/65/EU

[5] Using the same data set as above, and using 'Other investments' as being equivalent to non-MiFID investments or investment services, there were only 8 local authorities that only had 'Other investments' and did not record any value for any of the other types of investment (MiFID investments). The maximum number of firms we estimate were likely to be impacted was 8 on the assumption that each local authority was served by a different non-MiFID firm.

both MiFID and non-MiFID business. Local authorities receiving services as ECPs will continue to be able to receive the same services, just with added regulatory protections afforded to professional clients, and given the small numbers of firms and clients affected, we expect the impact to be negligible regarding the ECP proposals.

Price base year	Implementation date	Duration of policy (years)	Business Net Present Value	Net cost to business (EANDCB)	BIT score
2016	3 January 2018	10	-8.6	1.0	5.0

Please set out the impact to business clearly with a breakdown of costs and benefits

We sent out a questionnaire to around 5,000 FCA authorised firms in September 2015, asking for data to support its proposals for consultation in respect of all MiFID 2 changes. We then consulted on its proposals in a series of consultation during 2016 and 2017 on which it sought feedback on the proposals and the accompanying CBA.

In the section below we outline the costs to firms for the discretionary actions described above. The details presented below are drawn from underlying analysis conducted for the CBA in CP16/29 and which was finalised in PS17/14.

Costs

1. Categorisation of ECPs

MiFID II mandates that all elective professional clients will no longer be able to opt-up to elective eligible counterparty status. We have also opted to extend this proposal to non-MiFID business that uses the MiFID-style client categorisation regime under FCA rules. We believe the cost of the change implies only negligible costs, given the very small number of *elective* professional clients who in practice request elective ECP status (excluding Local Authorities, which are discussed below).

2. Re-categorisation of local authority clients

The impact of processing the re-categorisation of local authority clients alone by investment firms was estimated to involve negligible costs – instead, the main impacts stem from the consequent changes they have to make in how they provide services assuming they need to treat local authorities as retail clients. There would be potential one-off costs for firms such as staff training in dealing with retail clients, and making changes to client communication, compliance and legal procedures, as well as the possible need to obtain regulatory permissions to serve retail clients. Investment firms may face on-going costs from treating local authorities as retail, rather than professional clients, such as additional time spent verifying that local authorities fully understand investment risks and conducting suitability and appropriateness tests on certain products.

Using data for the financial year 2015/16, we believe 42 local authorities who were using MiFID services during that year, would be unable to opt-up to professional client status under our new rules. It is assumed that all local authority clients who can opt-up to elective professional client status will request to do so, and investment firms will accept their request where possible. Where local authorities are able to become *elective* professional clients, we do not believe there will be any additional ongoing costs from a situation under MiFID where such clients were *per se* professional clients.

The direct cost of applying for a change in regulatory permission to serve retail clients, where this does not already exist, is an application fee of £250 per firm. We believe many firms will have regulatory licences to serve retail clients already, and thus to the extent applicable is included with the cost estimates below.

Based on survey responses received, we believe the average one-off cost of implementing the regime is around £25,000 per firm. If 42 local authorities are impacted, this implies a cost estimate of £1.1m. However, this estimate is likely to be high, as it assumes that every local authority is served by a single investment firm and that each local authority is served by a different firm. We estimate that the on-going costs for investment firms of continuing to serve the same local authority but as retail clients, rather than professional clients, including meeting additional retail client requirements, is around £11,000 per firm per annum. If 42 local authorities are implicated, this implies ongoing costs of around £462,000 per annum.

The costs involved with also extending the requirements to investment firms' non-MiFID business with local authorities are estimated to be an average on-off cost of £95,000 and on-going cost of £45,000 per annum per firm. In practice, most firms doing non-MiFID business also do MiFID business, and therefore assuming common procedures, the additional cost of applying these proposals in relation to non-MiFID business is negligible. We believe that only around 8 investment firms who provide non-MiFID services to local authorities would be impacted in 2015/16, and therefore one-off costs would be £770,000 and on-going costs would be £350,000 annually.

We do not believe there will be any material additional costs from the proposed policy for investment firms to categorise local authority treasury functions and pension administration separately. Common processes will be used for each type of business (although with different criteria being relevant to each), and we received no evidence to suggest that running those processes separately for the two types of business of local authorities will impose any additional cost.

For changes in relation to the application of the high-level FCA Principles for Businesses, compliance will normally be met by meeting other MiFID and non-MiFID requirements. In other words, if firms meet the more detailed conduct of business or other relevant rules as will apply to their dealings with retail or professional clients; they should per se meet the relevant Principles for Businesses. We, therefore, do not expect this to result in any material costs related to behavioural or practical changes beyond those already captured above.

The changes proposed to client categorisation are expected to benefit consumers. For example, some consumers may benefit from the additional regulatory protections if they remain as an elective professional client. These benefits to consumers and society are likely to exceed costs to firms. However, under the Act, benefits to consumers and society are out of scope for impact assessments. These benefits are considered in our cost benefit analysis (CBA) prior to rule changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

The relevant FCA consultation paper for these provisions is: FCA, September 2016, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III, https://www.fca.org.uk/publication/consultation/cp16-29.pdf

The relevant FCA policy statement for these provisions is: FCA, July 2017, PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, https://www.fca.org.uk/publication/policy/ps17-14.pdf

FCA, Principles of Business, https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html

The European Commission published an impact assessment alongside its initial proposal for MiFID II, which included the client categorisation proposals, which can be found here: https://ec.europa.eu/info/file/33578/download_en?token=EMcmdZOS