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Changes to DFSA client classification regime. Good timing – an opportunity to consider proposals through the lens of possible "perimeter" issues raised by the Bank Sarasin judgment.

The Dubai Financial Service Authority (DFSA) has released a consultation paper outlining proposed changes to the client classification provisions of the Conduct of Business (COB) module of its rulebook.

Introduction

The DFSA has released Consultation Paper (CP) 97 inviting comments on the changes it proposes to make to the client classification regime in COB.

The proposals include:

- expanding the list of those who can be treated as *per se* professional clients;
- a new category of professional clients identified by reference to the financial service to be provided to it;
- dispensing with the net asset test for certain classes of professional clients;
- sub-categorising professional clients into: "deemed", "service-based" and "assessed";
- expanding the instances when the professional status of one person can be attributed to another person on the basis of ownership or family connections between the two;
- for "assessed" professional clients which are undertakings, flexibility to "look-through" to a controller, holding company, subsidiary or joint venture partner which can satisfy the tests;
- instances where the client classification made by head office or a member of its Group may be relied upon by the authorised firm;
- arrangements to apply where a "bundle" of financial services is provided by various members of the authorised firm's Group to the same client;
- flexibility to use an "umbrella" Client Agreement where there is financial services "bundling" by a Group;
- retail opt-in no longer available to *per se* professional clients; and
- net asset test threshold for individuals and undertakings will be raised from US$500,000 to US$1 million (uplift to occur in about a year's time).

The DFSA client classification regime was last modified in 2007 and these proposals are intended to address accumulated concerns and requests of firms and, in certain instances, to codify the basis upon which waivers and modifications have been granted to accommodate evolving market practices or structures.

The DFSA's stated aim is to enhance the regime in line with international best practice and remain true to IOSCO standards, as well as to draw from other well-established regulatory frameworks, in particular that operating in the UK, given its status as a proxy for the EU regime.

Certain proposals in CP 97 enter territory previously uncharted by regulators in jurisdictions operating broadly analogous frameworks (including the UK). This is especially the case for the DFSA's proposals to address issues arising in

circumstances where a firm provides financial services as part of a suite of services (or "bundle" – as it is termed in CP 97) provided to the same client (a "Group client") by other members of that firm's Group.

The proposed Group client arrangements provide for the outcomes the DFSA requires to be achieved where bundling occurs, in terms of the classification process itself and, additionally, by requiring a risk assessment and obliging the firm to ensure that the client has a clear understanding of the arrangements, particularly as to the respective responsibilities of the entities involved in providing the bundled services.

Quite lengthy draft guidance accompanies the Group client arrangements. This guidance touches on issues that, to a degree, resonate with the judgment recently delivered by the DIFC Courts in the Bank Sarasin case.[1]

In the Bank Sarasin case, an order was made against the bank in Switzerland (which has no presence in the DIFC) on the basis that acts carried out by employees of a connected DIFC-based joint venture entity authorised by the DFSA were to be imputed to the Swiss bank itself.

It was decided that these acts constituted a breach (by the Swiss bank) of the Financial Services Prohibition in the Regulatory Law, and that the losses resulting from the breach could be the subject of a claim for compensation (see Clifford Chance Briefing Note of September 2014).

The decision is likely to go to appeal, but irrespective of the particular facts of the case, the judgment highlights regulatory and litigation risks to which Group members outside the DIFC might be exposed with respect to financial services provided to clients of a DFSA authorised firm which is a member of the same Group. These and similar concerns are dimensions of what is often termed as the "perimeter" issue.

The Group client arrangements, and associated guidance in CP 97 reflect analogous concerns, although the DFSA is at pains to point out that the decision in the Bank Sarasin case played no part in framing CP 97 – the timing was a coincidence. Nonetheless, the timing is fortunate given the opportunity the consultation period affords to explore measures to mitigate risks not just in the context of client classification (strictly speaking the subject of CP 97) but as part of a wider consideration of the perimeter issue.

More about professional clients

Currently, the framework for classifying professional clients is based upon the status of the client, its assets and, where applicable, its experience and understanding of financial markets. CP 97 proposes revisions to the structure in two principal ways:

- creating sub-categories of professional client (and introducing new categories of professional client within one of those categories). The new categories of professional client are: "deemed", "service-based" and "assessed".
- in the case of one of these sub-categories ("service-based'), providing that the eligibility to be treated as a professional client is to be determined by reference to, *inter alia*, the nature of the financial service to be provided rather than exclusively as a function of the client's characteristics.

The criteria to be applied in determining whether a client may be classified as a professional client (or market counterparty) remain broadly the same (save in the case of service-based professional clients) i.e. the appropriate application of a net asset test and, where required, an assessment of the client's experience and understanding of financial markets, but there are proposed revisions which alter (i) the circumstances in which the net asset test and the experience test are required, and (ii) consequences of a professional client classification depending upon the category of professional client into which the client falls.

Deemed professional client

In broad terms, this is a client who is eligible to be treated as a professional client under the current COB framework, and in respect of whom the firm is entitled to impute the necessary degree of experience and understanding of financial markets etc. without having to undertake an analysis to determine that this is indeed the case.

CP 97 proposes that, in addition to dispensing with the analysis requirement for these clients, the application of a net asset test is not required, given that these clients will be, in the main, wholesale and institutional businesses, making the test redundant.

The list of deemed professional clients contains all those currently specified in COB 2.3.2 (2), except for "a Body Corporate which has called

[1] Case CFI 026/2009

up share capital of at least US$10 million" (essentially now covered by the new large undertaking category – see immediately below).

CP 97 adds three newcomers to the list:

- a large undertaking which, to qualify as such, must satisfy at least two of the following tests by having: (a) a balance sheet total of US$20 million, (b) a net annual turnover of US$40 million, or (c) own funds or called up capital of at least US$2 million;
- a trustee of a trust which has, or had during the previous 12 months, assets of at least US$10 million; and
- a holder of a licence under the Single Family Office (SFO) Regulations with respect to its activities carried on exclusively for the purposes of, and only in so far as it is, carrying out its duties as a SFO.

Significantly, CP 97 proposes that a deemed professional client cannot opt-in to be treated as a retail client.

Moving up to market counterparty

Deemed professional clients are eligible to be classified as market counterparties and so, neither the net asset test nor the experience analysis requirements are applicable.

As with the current version of COB, the proposals differentiate between certain categories of professional client to determine whether the client must expressly consent to the proposed market counterparty classification for it to be effective. As before, express consent is required from (a) a body corporate whose shares are listed on a regulated exchange of an IOSCO member country and (b) an entity in the "any other institutional investor" category in COB 2.3.2 (2) (i).

CP 97 additionally requires express consent from the new categories of deemed professional client it proposes, namely: a large undertaking, a trustee with more than US$10 million and a SFO Licence Holder.

Assessed professional client

A distinction will be drawn between individuals and undertakings when determining whether a client is to be classified as a professional client in the "assessed" category.

Under the net asset test, the threshold of US$500,000 is to be increased to US$1 million for individuals and, for undertakings, to a minimum of own funds or called up capital of at least US$ 1 million. The increase is to occur in about a year's time to provide sufficient advance notice to firms to consider the impact of the increase on their existing client base and what transitional arrangements need to be made.

An individual who is not a deemed professional client must meet the net asset test. Further, such an individual will need an assessment of their expertise. An exception lies with respect to an individual who has been an employee for the previous two years in a professional position of an authorised firm or a regulated financial institution. This individual can still be classified as an assessed professional client despite no analysis being required as long as the net asset test is met.

Undertakings

If an undertaking has a controller, holding company, subsidiary or joint venture partner who meets the professional client criteria, then the undertaking itself can be classified as a professional client.

Individuals: look-through

A new category of look-through arrangements relating to joint accounts operated by family members is to be introduced. Family members of a professional client can be classified as professional clients if:

- the primary account holder meets the professional client criteria; and
- the other joint account holders confirm in writing that the primary account holder is authorised to make investment decisions relating to the account.

Service-based professional client

This is a new category of professional client classification determined by reference to the financial services being provided to undertakings (i.e. not individuals) in circumstances where the view has been taken that the benefit of the additional regulatory protection offered to retail clients is not necessary. The relevant services are: (i) providing credit and (ii) corporate advisory and arranging services.

When classifying clients for the purposes of providing these categories of services, an authorised firm is not required to undertake any assessment of the client's expertise or net assets to be classified as a professional client but there must be a reasonable basis for the classification falling within these proposed categories.

Providing credit

Service-based professional client status may be given to a client of an authorised firm where:

- the financial service is providing credit;

- the client is an undertaking; and
- credit is provided to the undertaking for use in the business activities of the undertaking (or a related party of that undertaking) i.e. commercial returns from non-commercial credit.

The scope will be extended for an undertaking where credit is obtained not only for its business use but also where it is to be used in the businesses of a controller of the undertaking or a member of the undertaking's group, as well as a joint venture of the undertaking or its controller or member of its group.

Corporate advisory and arranging

Service-based professional client status may be given to clients obtaining the services of 'advising on financial products or credit' or 'arranging credit or deals in investments' for the purposes of corporate structuring and financing. These clients are considered to have sufficient expertise and resources. The status is not similarly extended to clients obtaining comparable services for private wealth management purposes - these clients can only be considered professional clients after assessing their net worth and expertise.

Opt-in as retail client

Only service-based and assessed professional clients will have the right to opt-in as retail clients.

Other New Measures

Reliance on classifications made elsewhere

There is a proposal to allow firms to rely on client classifications made elsewhere, for example, in the case of a branch, by its head office or another branch of the same legal entity. Certain conditions must be met:

- having conducted a gap analysis, the firm must have reasonable grounds to believe that the required DFSA tests are met;
- if any gaps are identified the firm must address them; and
- the firm must be able to demonstrate that the reliance on such client classification is reasonable and appropriate.

Group clients arrangements

Where the firm provides one or more financial services as part of a bundle of financial services provided to a client by the firm's Group, the firm must ensure:

- the client classification adopted by the firm remains consistent with legal requirements and is appropriate for the overall financial services provided to the client;
- the client has a clear understanding of the arrangement; and
- any risks arising from the arrangement are identified and appropriately and effectively addressed.

Guidance is provided to address risks such as conflicting legal requirements in the jurisdictions where the members of the group are located, difficulties in identifying the entity providing the service and the resulting greater exposure to legal risk by members of the group. There is also guidance on systems and controls.

The requirements are not to be extended to a branch as it is not a separate legal entity. However, to the extent that a branch conducts its activities on a stand-alone basis, it may use the same approach.

Client agreement provisions

As the client agreement provisions in COB are closely associated with the classification requirements, there is a proposal to restrict the ability of an authorised firm to rely on a client agreement made by another entity except in two instances:

- where the authorised firm is a branch and the client agreement is made by its head office or any other branch of the same legal entity. The client agreement must clearly cover the financial services provided by the branch; and
- where the authorised firm provides a financial service as part of a bundle of financial services. If the firm is relying on a client agreement executed by a member of its Group, the agreement must clearly identify the financial services provided by the firm and state the client's rights under the contract.

Clifford Chance Comment

So far so good. The proposals contain much that is to be welcomed. It is a reflection of the growing maturity of the DFSA ten years on from its establishment.

As highlighted in the Introduction, an innovative element in these proposals is the concept of a bundle of financial services (proposed new Rule 2.4.5 in COB). In a world where politicians demand greater attention by financial regulators to matters of domestic concern, the DFSA's recognition of the cross border nature of financial services provision is welcome. Most business conducted through DFSA authorised firms is booked in entities and locations outside the DIFC.

Acknowledging the composite manner in which financial services and

products may legitimately be delivered to customers via DFSA firms subject to its rules is a positive step for the DFSA to take. Again, as already suggested, the current consultation period should help inform the appropriate policy response to issues raised by the Bank Sarasin case.

The guidance to Rule 2.4.5 recognises the complexity in seeking to address the legal, documentary and operational dimensions of providing "bundled" financial services, and serves as a good pointer to some of the questions that will have to be answered by firms.

We believe that further analysis is desirable in respect of certain key aspects of the Rule and the guidance, including (the following is not intended to be exhaustive):

- to what level of detail should guidance in this sphere go? The possible scenarios are numerous – is there potential to do more harm than good by "over-guiding"?
- the scope and meaning of a "bundle" (again the multitude of possible permutations);
- the concepts of responsibility and accountability alluded to in the guidance – these expressions are freighted with significant legal meaning in all jurisdictions, and therefore in Group client arrangements the risk of unintended legal and regulatory consequences is magnified;
- whether the distinction between branches and stand-alone entities in the context of the Rule and the guidance requires further refinement;
- the interaction of the Rule with GEN systems and controls requirements; and
- whether there is merit in drawing out and addressing perimeter issues in separate guidance that is not exclusively associated to the application of COB classification Rules.

Conclusion

CP 97 represents a welcome and thorough update of the DFSA's client classification regime.

It also provides an important platform upon which the perimeter issue can be further explored to determine the extent to which the associated legal and regulatory risks might be mitigated.

We imagine that many firms and other interested parties will be contributing to the consultation process, as shall Clifford Chance.

Authors

Tim Plews
Partner

T: +966 555 156 153
E: tim.plews
@cliffordchance.com

James Abbott
Partner

T: +971 4 362 0608
E: james.abbott
@cliffordchance.com

Philip Jolowicz
Counsel

T: +971 4 362 0742
E: philip.jolowicz
@cliffordchance.com

Ricky Ghosh
Associate

T: +971 4 362 0706
E: ricky.ghosh
@cliffordchance.com

Chris Young
Associate

T: +971 4 362 0616
E: christopher.young
@cliffordchance.com