ISSUE 2

Robust Onboarding is Key to Customer Classification Compliance Under MiFID, FATCA and EMIR

As the push for transparency continues to evolve under MiFID, FATCA and EMIR, robust onboarding practices that comprehensively capture key attributes of each client, owner and counterparty will be needed to meet reporting requirements for customer classification. These regulatory schemes nudge existing AML/KYC systems into the realm of tracking client sophistication and understanding the purposes and goals of each account.

MIFID: DETERMINING LEVELS OF CLIENT SOPHISTICATION

Markets in Financial Directive (MiFID I) was implemented in the UK in 2007 and MiFID II is now before the European Parliament. According to the Financial Conduct Authority (FCA) (http://www.fca.org.uk/your-fca/documents/mifid), a goal of MiFID I was to harmonize requirements related to the internal conduct of firms with increased transparency of trading activity in the markets. The aim of MiFID II is to build on the MiFID I framework and address gaps in transparency and technological advances.

The Proposal for a Directive (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF) for MiFID II notes that while MiFID I has created more competition between trading venues and more choice for investors in terms of providers of financial services, reforms to the MiFID framework are needed to establish a "safer, sounder, more transparent and more responsible financial system" in the EU.

MiFID I classifies clients into the categories of retail, professional and eligible counterparties. Non-professional clients, who are considered to be less sophisticated with respect to financial products, generally fall into the retail category. Investment firms, credit institutions and insurance companies are examples of clients that fall into the professional category. The most sophisticated investors are considered eligible counterparties. Under the MiFID scheme, it is possible for a client to receive multiple classifications. For example, a client may be deemed a retail client for certain transactions while being considered a professional for others based on the client's knowledge and experience with certain types of products or services.

In addition to knowledge and experience, classification is based on the client's financial situation and investment objectives. Therefore, not only is it important to gather information on these factors during the onboarding process, this information must be regularly reviewed as a client gains sophistication and as its investment goals evolve.

The Proposal recommends extending heightened protections to non-retail clients and recognizes that the existing MiFID framework of classification may be inadequate, especially with respect to transactions involving municipalities. The Proposal contemplates excluding municipalities from the eligible counterparties category and allowing them to request treatment as professionals. The Proposal also suggests that some information and reporting requirements that apply to retail and professional clients should be extended to dealings with eligible counterparties.

FATCA: UNDERSTANDING THE PURPOSE AND NATURE OF AN ACCOUNT

The primary objective of FATCA is to identify U.S. tax evaders who invest in off-shore accounts either directly or indirectly through ownership of foreign entities. Two nets that are widely cast involve requirements for Foreign Financial Institutions (FFIs) to report information on foreign accounts to the IRS and for passive Non-Financial Foreign Entities (NFFEs) to provide information on substantial U.S. owners to withholding agents. These FATCA requirements place a burden on FFIs and NFFEs to collect, validate and maintain sufficient documentary evidence on the identities of clients and owners.

Under the FATCA classification scheme, FFIs and NFFEs must also determine whether they have a "reason to know" that any client or owner claims are unreliable or incorrect and they must monitor whether there are changes in circumstances that would lead to a reclassification of a client or owner.

The Final Regulations for FATCA (http://www.irs.gov/PUP/businesses/corporations/TD9610.pdf), effective January 17, 2013, state that a person's entity classification is the same as the person's entity classification for U.S. tax purposes. According to the regulations, for example, "an entity that is disregarded as a legal entity in its country of organization . . . will be treated as an entity [under FATCA] if it is an entity for U.S. federal income tax purposes." Further, a withholding agent may rely on an entity classification set forth in a valid Form W-8 or W-9 if the withholding agent "has no reason to know that the entity classification is incorrect."

The final FATCA regulations define "AML due diligence" rather generically as the "procedures of a financial institution pursuant to the anti-money laundering or similar requirements to which the financial institution, or branch thereof, is subject." The regulations note, however, that AML procedures are key to "identifying the customer (including the owners of the customer), understanding the nature and purpose of the account, and ongoing monitoring.

Thus, while FATCA does not specifically mandate that AML/KYC onboarding

processes be changed to comply with FATCA, it does require that data collected during the onboarding process be reviewed for indicators of U.S. status for FATCA classification purposes. This essentially introduces a tax review function to the AML/KYC process.

Many FFIs are required to enter an FFI Agreement with the IRS to designate a Responsible Officer (RO) who serves as the single point of contact for IRS inquiries and who is responsible for proactively making certain FATCA certifications to the IRS on an ongoing basis. The RO must show that the FFI has adopted written policies and procedures related to customer due diligence, withholding and reporting under FATCA. Further, the RO must periodically certify that the FFI has conducted FATCA compliance reviews including the disclosure of any material failures.

EMIR: REPORTING BY ONE, AGREED UPON BY ALL

The European Market Infrastructure Regulation (EMIR) (http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ:L:2013:052:TOC), issued in 2012, is applicable to EU member states and certain counterparties and strives to increase transparency in the derivatives market by calling for central clearing – or at least central reporting – of all OTC derivative contracts.

EMIR – fashioned by recommendations and technical standards drafted by the European Securities and Markets Authority (ESMA) – mirrors swap regulations issued under Dodd-Frank. EMIR classifies counterparties to OTC derivatives contracts as either Financial Counterparties (FCs) or Nonfinancial Counterparties (NFCs) with NFCs further identified as either high volume users of OTC derivatives (exceeding a clearing threshold) or sub-threshold users.

To ascertain the correct counterparty classification, a non-EU entity must first determine whether it would be an FC if it were located in the EU. If it would be an NFC, then its threshold level must be calculated based on factors such as transactions entered into within affiliated groups and asset classes of the OTC derivative contracts.

EMIR allows one counterparty to delegate reporting responsibilities to the other counterparty and also allows both counterparties to delegate reporting to a "common third entity including a central counterparty (CCP)" with the CCP submitting one report to the trade repository. The requirements for serving as a CCP are extensive including, but not limited to, maintaining (1) an adequate staff to meet obligations arising from EMIR, (2) comprehensive management of all material risks including risks the CCP bears and poses to settlement banks, liquidity providers, central securities depositories and trading venues, (3) an "effective compliance function which operates independently from the other functions of the CCP" and (4) information technology systems based on "internationally recognised technical standards and industry best practices."

The "Counterparty ID" and "ID of the other counterparty" are the essential strings of data collected under EMIR with respect to identifying the parties to an OTC derivative transaction. An ID is a unique code for each party that represents items such as corporate name, domicile, and corporate sector.

These ID attributes are reported "from the perspective" of the reporting counterparty or CCP. The reliability of the data, therefore, rests with the accuracy of the collection system of the reporting party. Ultimately, however, agreement among all involved is imperative because EMIR requires that "details reported shall include the full set of details that would have been reported had the contracts been reported to the trade repository by each counterparty separately."

The EMIR model differs from Dodd-Frank on the issue of portfolio reconciliation. Under Dodd-Frank, reconciliation is the responsibility of the swap dealer but not the end user. Under EMIR, however, both parties to an OTC derivatives contract are required to reconcile their portfolios based on data collected.

Through EMIR, the EU has adopted risk mitigation rules similar to those issued by the CFTC in the U.S. applicable to swap dealers. In fact, the EU is collaborating with the CFTC to continue to harmonize swap processing and reporting rules.

The evolving requirements of MiFID, FATCA and EMIR with respect to customer classification will require AML/KYC onboarding systems to capture more data and routinely review data from a more subjective standard to determine changing levels of client sophistication and to recognize when underlying goals shift.

How is your institution preparing to meet these new customer classification challenges?

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