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Additional Information

Level 1 Regulation

Markets in Financial Instruments Directive II (MiFID II) Directive 2014/65/EU- Investor Protection and Intermediaries

Topic

Suitability

Subject Matter

Suitability and appropriateness

Question

What are the obligations on a firm when a specific financial instrument is unsuitable for a client, in particular also in situations when the client wishes to proceed with the transaction nonetheless?

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Original language

[ESMA35-43-349 MiFID II Investor protection Q&As, ch. 2 question 6]

When providing investment advice, firms are required under Article 25(2) of MiFID II to recommend to the client (or potential client) only the investment services and financial instruments that are suitable for him/her and, in particular, are in accordance with his risk tolerance and ability to bear losses. Recital 87 of the MiFID II Delegated Regulation clarifies that a suitability assessment should be undertaken “not only in relation to [when] recommendations to buy a financial instrument are made but for all decisions whether to trade including whether or not to buy, hold or sell an investment”.

Therefore, firms should avoid any behaviour that might result in a breach of the rules on suitability. Examples of clearly incorrect behaviours (see, for example, Case 1 and Case 2 below) could be situations where the purchase of a specific financial instrument cannot be recommended to a client because that instrument is unsuitable for him and the firm influences that client to proceed with the transaction at his/her own initiative (for instance, by emphasising only the positive aspects of the product); or where the firm purposely changes the client's profile (without there being any real change in the client's situation that would justify such a modification of the profile) in order to make suitable a financial instrument that is unsuitable for him/her, so as to be able to recommend it.

CASE 1: Client A has an ongoing relationship with Firm X for the provision of investment services, including investment advice. Firm X has a contractual relationship with a third party (e.g. Company Z) for selling products issued by Company Z itself.

Client A would like to make an investment and, in the context of his relationship with Firm X, asks for an advice from the firm. The firm, knowing that an investment in products issued by Company Z would be unsuitable for client B, deliberately raises his profile (although no changes in the clients' situation, that would justify such a change, have effectively occurred), so as to be able to recommend them.

CASE 2: Client B has an ongoing relationship with Firm Y for the provision of investment services, including investment advice. Firm Y is also the issuer of product Y and has a specific interest in placing it in order to meet its funding needs.

In the context of the relationship with client B, the firm, being aware that product Y would not be suitable given the client's financial situation, their investment objectives and their knowledge and experience, decides to influence him to buy product Y at his own initiative, for example by emphasising all possible advantages of such an investment. As a consequence, the client executes the transaction under the appropriateness test or execution only, without the protections afforded by the suitability assessment.

On the contrary, there might in practice also be situations (see, for example, Case 3 below) where the firm is confronted with clients who insist in taking a course of action that the firm has assessed as being unsuitable for him/her, therefore acting against the firm's advice (so called 'insistent clients').

CASE 3: Client C has an ongoing relationship with Firm W for the provision of investment services, including investment advice.

In the context of this relationship, client C contacts the firm at its own initiative, asking its advice about what investment he should choose between product A and product B. The firm, that does not have any specific interest in selling either of the mentioned products, undertakes a suitability test and assesses that only the investment in product B is suitable for client C, but despite the firm's recommendation, the client insists in buying product A. Client C will therefore execute the transaction under the appropriateness test (if the product is complex) or at his own risk, in execution-only (if the product is not complex and the transaction is regarded as being at the client's initiative), despite the firm's advice not to buy product A.

In situations where the client insists in proceeding with the transaction at his/her own initiative, against the firm's advice, that client should be clearly informed of the fact that the course of action that he/she wishes to undertake is not suitable for him/her, including a clear explanation of the potential risks he would incur into by doing so.

In order to ensure compliance with MiFID II framework, firms should in any case put in place arrangements enabling them to retrace and keep records of the steps of their interaction with

clients, so as to be able to demonstrate whether the transaction executed was indeed originated by the client's initiative¹ or by the firm's initiative. Firms should periodically review these records to monitor that the interaction with their clients was correctly conducted and to identify potential practices and behaviours non-compliant with MiFID II rules. For example, recurring switches from investment advice to execution services at the client's initiative, or changes of client's profiles near the closing date of any transaction, not supported by a real modification of the client's situation that would justify such a change.

There are particular instances, such as firms selling their own financial instruments (or selling financial instruments issued by entities of the same group) or actively marketing products from within the firm's range, where there is a heightened risk that a firm might indeed act in accordance with its own interests, rather than in the best interests of its clients. In such circumstances, where there is a heightened risk of non-compliance with MiFID II rules due to the existence of significant conflicts of interests, firms may also decide, of their own accord and where compatible with national laws, to put in place processes and procedures that do not allow the client to proceed with a transaction under execution services in relation to a specific financial instrument if that instrument is unsuitable for him. Similar arrangements could also be adopted in relation to insistent clients.

Firms remain subject to all relevant MIFID II requirements and, in particular, to the overarching obligation of acting in accordance with the best interests of their clients.

1. Recital 85 of MiFID II states that "a service should be considered to be provided at the initiative of a client unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients."