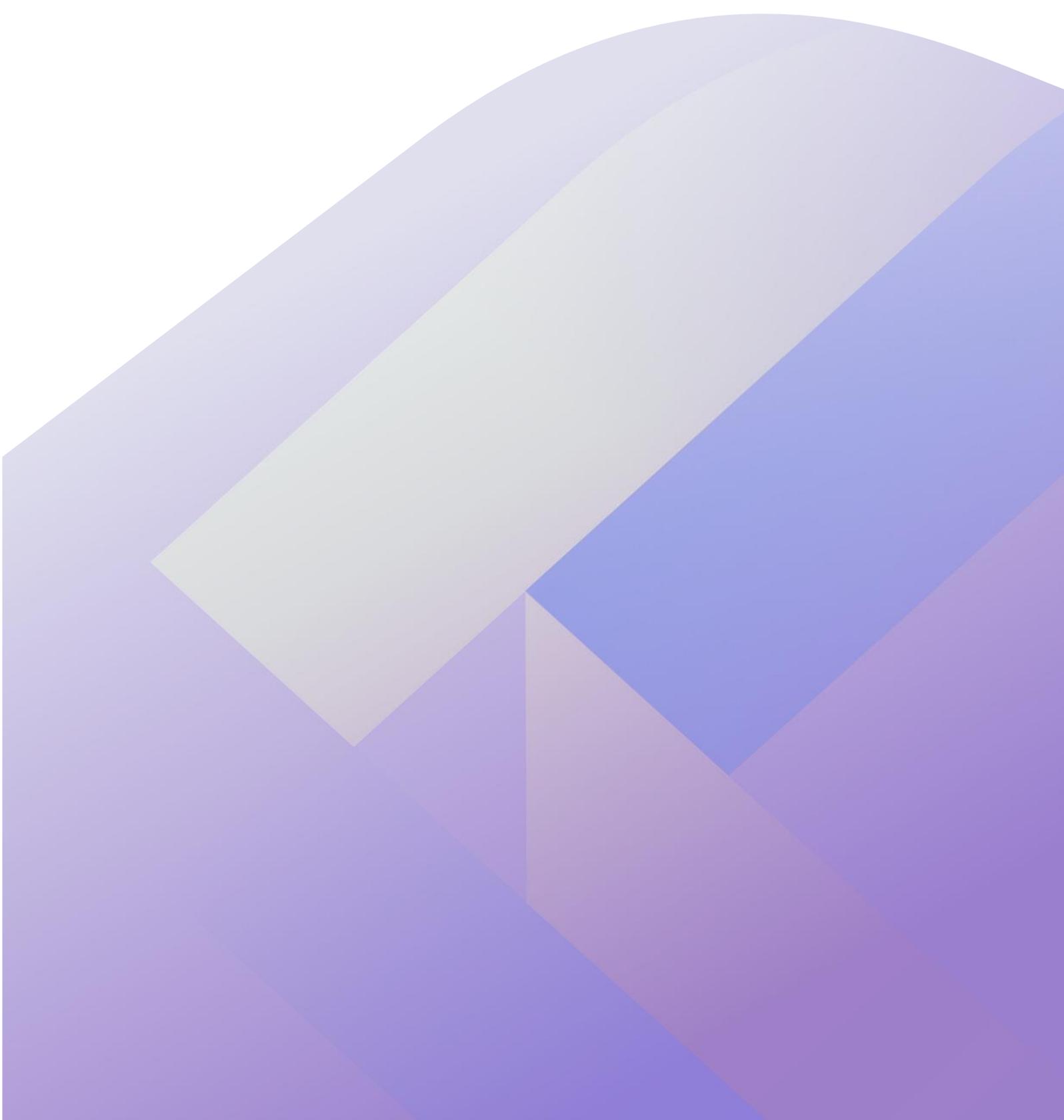


# Supervisory Briefing

**On supervisory expectations in relation to firms offering copy trading services**



## Table of Contents

1	Introduction .....	2
1.1	Overview .....	2
1.2	Scope.....	2
1.3	Status of this document.....	3
1.4	Purpose.....	4
2	Supervisory expectations .....	5
2.1	Examples of copy trading .....	5
2.2	Qualification of the investment service .....	7
2.3	Information requirements: marketing and costs and charges.....	11
2.3.1	General information requirements including marketing.....	12
2.3.2	Costs and charges disclosures.....	13
2.4	Product governance requirements.....	14
2.5	Suitability and appropriateness requirements.....	15
2.5.1	Provision of investment advice or portfolio management service.....	16
2.5.2	Provision of RTO or execution of orders.....	17
2.6	Remuneration and inducement requirements.....	19
2.7	Qualifications of copied traders .....	22

# 1 Introduction

## 1.1 Overview

1. In accordance with the ESMA Regulation<sup>1</sup>, ESMA's objectives include fostering investor protection and actively promoting supervisory convergence across the Union with the aim of establishing a common supervisory culture.

2. In June 2012, ESMA published a Q&A in relation to the legal qualification of the automatic execution of trade signals. This supervisory briefing takes into account this Q&A and sets out supervisory expectations with regard to its application as well as to the compliance with respective MiFID II<sup>2</sup> requirements applicable to firms that provide copy trading services. The supervisory briefing sets out the supervisory expectations of both ESMA and National Competent Authorities (NCAs) in order to ensure effective and consistent application of the requirements and hence to foster convergence in supervisory outcomes. The briefing also includes indicative questions that supervisors could ask themselves, or firms, when assessing firms' approaches to the application of the relevant MiFID II rules.

3. ESMA and NCAs will continue monitoring the development on this topic and may therefore undertake other steps in the future to assure that copy trading services are provided in a manner that is consistent with the applicable MiFID II requirements and that these services are being provided in the best interest of the client.

4. The content of this briefing is not exhaustive, it does not constitute new policy, nor does it promote any particular way of supervising the rules. The briefing has been designed to be used in a manner which best fits with supervisors' methodologies (whether distributing the briefings internally, or passing them to external bodies, such as auditors, for example).

## 1.2 Scope

5. As said, this supervisory briefing contains the supervisory expectations of ESMA and NCAs<sup>3</sup> in relation to firms providing copy trading<sup>4</sup> services. Copy trading refers to a service that involves trading of a client's assets based on the trades of another trader (hence adding a

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<sup>1</sup> Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC as amended by Regulation (EU) 2019/2175

<sup>2</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, hereinafter MiFID II.

<sup>3</sup> In accordance with Article 4(26) of Directive 2014/65/EC.

<sup>4</sup> Throughout the supervisory briefing we use the term 'copy trading' as collective reference. Copy trading, in general, allows investors to trade by automatically copying another investor's trades. There can be different types of copy trading models and the terminology used for the provision of these types of services can therefore differ as well.

Sources: Analysis & Insights from The World Of Finance & Business (globalbankingandfinance.com), The Central Bank of Ireland, and firms' websites.

social element) whom we refer to as the ‘copied trader’<sup>5</sup> (also identified as the ‘signal provider’). The trading usually is automated in this case, but it could also involve (partially) manual trading of the client’s assets.

6. The supervisory briefing covers the following aspects:

- Qualification of copy trading services;
- Information requirements: marketing and costs and charges;
- Product governance requirements;
- Suitability<sup>6</sup> and appropriateness assessment;
- Remuneration and inducement requirements; and
- Qualifications of firm staff<sup>7</sup>.

7. Each aspect refers to the relevant legislation and other guidance available.

8. In this supervisory briefing “firms” means firms subject to the requirements set out in Articles 25 (2), (3) and (4) of MiFID II and include investment firms (as defined in Article 4(1)(1) of MiFID II), credit institutions when providing investment services and activities (within the meaning of Article 4(1)(2) of MiFID II), investment firms and credit institutions (when selling or advising clients in relation to structured deposits), external Alternative Investment Fund Managers (AIFMs) (as defined in Article 5(1)(a) of the AIFMD<sup>8</sup>) when providing investment services under Article 6(4) of the AIFMD and management companies (as defined in Article 2(1)(b) of UCITSD<sup>9</sup>), when providing investment services under Article 6(3) of UCITSD.

### 1.3 Status of this document

9. The supervisory briefing is issued under Article 29(2) of the ESMA Regulation which enables ESMA to develop practical instruments and convergence tools, such as supervisory

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<sup>5</sup> ‘Copied traders’ are the traders whose trades are copied by a client of the firm. The copied trader is considered to be the “signal provider” to the firm which is executing the trades on behalf of its clients. The clients copying the trades can be identified as ‘copy traders’ (investors who copy trades from the copied traders).

<sup>6</sup> Relevant in cases where copy trading qualifies as portfolio management or investment advice.

<sup>7</sup> Relevant depending on whether copy traders qualify as staff.

<sup>8</sup> DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD)

<sup>9</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

briefings. The purpose of these tools is to promote common supervisory approaches and practices.

10. The content of this supervisory briefing is not subject to any 'comply or explain' mechanism for NCAs and it is not binding.

## 1.4 Purpose

11. For the purpose of this briefing, we do refer to the provision of copy trading services in general, where a retail client – to whom investment services are provided and as part of these services – is able to copy trades from a copied trader (whose trades are therefore being copied).

12. The ESMA Q&A 9 on article 4(1)(9) MiFID<sup>10</sup> as published in 2012, in relation to automatic execution of trading signals, provides guidance on the possible qualification of some forms of copy trading services.<sup>11</sup> In this Q&A, the question posed is whether automatic execution of orders on financial instruments by a firm based on trade signals issued by a third party can fall within the scope of the investment services as listed in Annex I of MiFID. The answer specifies that such service falls under the definition of portfolio management where the order execution is automatic and does not require any further action from the client. If client action is required, investment services other than portfolio management may be identified (e.g., investment advice, and reception and transmission of orders (RTO)). The 2012 ESMA Q&A remains relevant for copy trading business models since the majority of copy trading service providers provide for automatic execution of the transactions.

13. Both MiFID II and the MiFID II Delegated Regulation<sup>12</sup> place various requirements on firms providing investment services. Among these requirements, Article 16(2) of MiFID II, concerning the organisational requirements, requires firms to establish adequate policies and procedures sufficient to ensure the compliance of the firm with the obligations under MiFID II including, inter alia, information requirements<sup>13</sup>, product governance requirements<sup>14</sup>, the suitability assessment<sup>15</sup>, outsourcing requirements<sup>16</sup> and the knowledge and competence of staff<sup>17</sup>.

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<sup>10</sup> Considering the Q&A was published in 2012 it refers to MiFID and not MiFID II. The corresponding references as referred to in the Q&A in MiFID II would be the following: article 4(1)(8) MiFID II and Annex I MiFID II

<sup>11</sup> [EXT-ESMA-2012-382 MiFID QA 20120620 final \(europa.eu\)](#)

<sup>12</sup> Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

<sup>13</sup> Article 24(3) of MiFID II

<sup>14</sup> Articles 16(3) and 24(2) of MiFID II

<sup>15</sup> Article 25(2) of MiFID II

<sup>16</sup> Articles 16(2) and 16(5) first paragraph of MiFID II

<sup>17</sup> Article 25(1) of MiFID II

14. Furthermore, Article 16(3) of MiFID II requires firms to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Articles 23 and 24 of MiFID II which include, inter alia, conflicts of interest resulting from remuneration and inducement structures.

15. The present supervisory briefing provides the common understanding of ESMA and NCAs with regard to the supervision of firms offering copy trading services and it aims at contributing to the development of a convergent supervisory culture across the Union. The briefing is also meant to give indications and clarifications to market participants of compliant implementation of the MiFID II requirements applicable to (the different forms of) copy trading services. To do so, this supervisory briefing integrates in part existing supervisory briefings (such as the supervisory briefing on suitability for example) and adds aspects relevant to copy trading business models.

## 2 Supervisory expectations

### 2.1 Examples of copy trading

16. Firms' copy trading business models can be organised and offered in different ways. It is important to assess these business models on a case-by-case basis. By means of introduction, this first part of the supervisory briefing will describe possible examples of such business models, before going into more detail regarding the qualification of the investment service that is being provided. The examples provided below give information about the possible links between firms, copied traders (or signal providers) and clients. The examples are not meant to be interpreted as an exhaustive list, since copy trading services might take different forms and may still further develop.

17. A first example is where investment firms offer the possibility to their existing clients to share their trades with other clients. In this example, both the client sharing their trades (the copied trader) and the client copying these trades (the copy trader) are clients of the same firm. Thus, the copied trader shares their trades with other clients of the same firm for them to copy and the firm executes the orders. In this example a commercial contract might be in place between the copied trader and the firm, on the basis of which the copied trader may, for example, receive benefits from the firm.<sup>18</sup> Alternatively, an employment contract could be in place<sup>19</sup>, insofar that copied trader receives, for instance, a (fixed) remuneration by the firm

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<sup>18</sup> These benefits could qualify as inducements in accordance with MiFID II. Please refer to section 2.6 of this briefing for the remuneration and inducement requirements

<sup>19</sup> The qualification as to what constitutes an employment contract and what criteria need to be considered, is a matter of national law and may therefore vary from one MS to another.

executing the orders. There could be other forms of exclusivity or direct links between the copied trader and the firm, depending on the case.

18. A variation of the abovementioned type of copy trading services is when the firm allows clients to copy the trades of copied traders, but these copied traders share their trades on an external platform created by a third party. In this example, the firm provides clients with all services inhouse but does not gather the signal themselves. The firm may therefore not have a direct commercial or employment link with the copied traders, but only with the platform. The platform in this example is not an investment firm.

19. However, it could also be the case that two investment firms are involved in the provision of copy trading services. For instance, the first investment firm acts as an intermediary between signal providers (copied traders) and investors copying the trades. This firm collects/gathers/pools trade signals provided by copied traders and then allows clients to subscribe to receive the signals, but this firm does not execute the orders. Instead, the orders submitted are subsequently transmitted for execution to a second investment firm. This is particularly the case when the first investment firm is a copy-trading tool provider who has access to different trades from copied traders and provides the clients with trade signals, but the actual orders are executed by the other, often related, investment firm providing execution of orders service. Here it will be relevant to assess on a case-by-case basis whether the clients copying the trades are client of the first investment firm or the second firm.

20. A variation to the aforementioned business model described is where one investment firm decides to outsource part of its service to a third party. It could be the case for example that a firm outsources the provision of parts of investment advice. Outsourcing arrangements can take different shapes and forms. Particular consideration needs to be paid to the MiFID II requirements related to outsourcing of critical and important operation functions (Articles 16(2) and 16(5) of MiFID II and Articles 30 to 32 of the MiFID II Delegated Regulation) and respective authorisation requirements that could apply to the third party depending on the case (for example depending on the type of function exercised).

21. A different case is possible when the firm's client uses information provided by other individuals on social platforms or websites designed solely for such purposes and then (s)he gives orders for execution to the investment firm in where (s)he has a brokerage account. In this example, the order is coming directly from the client (copy trader) to the firm, therefore, no direct link can be determined between the firm executing this order and the copied trader on social media.

22. In the examples described above, investment firms and NCAs should be aware that the relationship between the copied traders and the investment firm allowing its clients to copy trades may differ and may constitute:

- i. outsourcing, which would arise, by way of an example, in the scenario where the investment firm provides its clients with signals provided to that firm by another entity. This could take the form of, for example, outsourcing of a part of its portfolio management activity (when there is an automatic execution of orders based on those signals), or parts of investment advice (when the service can be qualified as such);
- ii. employment, when the copied trader is in fact a person employed in the firm and subordinated in an organisational sense or there is some form of exclusivity and continuity in the relationship between the copied trader and the company<sup>20</sup>;
- iii. agency relation, which may arise when the copied trader promotes the particular firm when sharing their trades; or
- iv. another type of relationship based on a commercial contract.

23. The relationship in place should be analysed on a case-by-case basis. Investment firms should therefore ensure that all the obligations arising from MiFID II, depending on the specific relationship, are addressed, in particular on avoidance and management of conflict of interest and protection of the clients' best interest.<sup>21</sup>

## 2.2 Qualification of the investment service

24. Since 'copy trading services' are not defined by MiFID II it is important to determine and qualify the investment service being provided by the firm in question. Such qualification of the investment service is of importance to determine which authorisation the firm should obtain as well as other relevant MiFID II requirements that are applicable.

25. When looking at the qualification of copy trading services by firms, it is relevant to look, on a case-by-case basis, at the firm-client relationship and to look at the role the involved firms play when providing the service. For instance, while one firm may provide the signals but may not execute them, other firms may provide both the signals and execute them. Therefore, the roles and the obligations of firms involved can differ.

26. Investment firms should assess what type of investment service is triggered when providing copy trading services according to different models.

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<sup>20</sup> The qualification as to what constitutes an employment contract and what criteria need to be considered, is however a matter of national law and may therefore vary from one MS to another.

<sup>21</sup> For example, in case of an outsourcing agreement, the MiFID II Delegated Regulation requires the firm providing outsourced services to have any authorisation required by law to perform the outsourced functions.

27. In accordance with Article 4(1)(8) of MiFID II, ‘portfolio management’ is defined as “managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments”. Therefore, portfolio management is characterised by the discretionary nature of the mandate<sup>22</sup> between the client and the firm. The investment decisions are, in this case, being implemented without any intervention by the client, other than the mandate in place stipulating the nature and details of the discretionary service to be provided.

28. The aforementioned explanation was also relevant in the Q&A published by ESMA in 2012. The question concerned the situation in which a firm directly executed buy or sell orders resulting from signal providers chosen by the client, or passed them to another firm for execution, without further intervention from the client, and posed the question as to whether this service falls within any of the investment services listed in Annex I of MiFID. The answer concluded that the described arrangement requires authorisation in relation to portfolio management.

29. On the contrary, as described in the 2012 ESMA Q&A, when client action is required prior to each transaction, the activity performed by the firm should not be qualified as portfolio management. Depending on the interaction with the client, other investment services may still be relevant, notably investment advice in the case of personal recommendations and RTO or execution of orders (when no personal recommendation is provided to the client)<sup>23</sup>. Such assessment needs to be made on a case-by-case basis.

30. In the case in which a client is copying trades shared with them on social media, for example, and the client is subsequently directly giving an order to the firm to execute, then the firm is likely to provide execution services only. However, in this particular example, it will need to be assessed if this would constitute a copy trading service provided by the firm directly or at all. Considering that the firm might not be facilitating a copy trading service in this case. It should be noted that in this case, the trades that are being shared on social media could still qualify as investment advice provided by the copied trader who share their trades<sup>24</sup>.

31. If, however, one single firm is involved in the provision of copy trading services to its clients and the firm has a (direct) link to the copied traders, then it seems highly unlikely that this firm is only providing execution services.

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<sup>22</sup> Mandates come in different forms. In copy trading clients can, for example, sometimes have the option to click on ‘autocopy’ or ‘auto-follow’ online buttons which effectively are the mandates to the firm to automatically execute the trades of the signal provider (in this case the copied trader). Article 58 of the MiFID II Delegated Regulation is relevant here when assessing client agreements.

<sup>23</sup> In addition, the RTO or execution of orders could be combined with the provision of investment advice. Furthermore, the case in which the recommendation does not constitute a personal recommendation, the recommendation could potentially qualify as a general recommendation relating to transactions in financial instruments which could be relevant under the Market Abuse Regulation.

<sup>24</sup> Generally speaking, the provision of an investment service could be identified even in situations in which the trades shared by the copied trader are not actually copied on a live basis.

32. When there are two firms involved in the copy trading service, where the execution of orders is done by a second firm, then each of the firms involved may offer a different type of investment service. For example, the firm that is collecting (pooling) the signals could have a contractual relationship in place with the copied trader (signal provider) and be providing a part of the copy trading service vis-à-vis their clients (in this case it is also possible that this first firm provides signals themselves instead of pooling the signals). In this example, the first firm (the signal providing/pooling one) provides either portfolio management (when there is an automatic transmission of orders without any client intervention), or investment advice (if applicable) together with RTO. The second investment firm, receiving the orders from the first firm<sup>25</sup>, is providing the service of execution of orders in the examples at hand.

33. When the service qualifies as portfolio management, the decisions to deal (transactions) are taken by firms on behalf of their clients. In some copy trading business models clients could be enabled to modify or reject a transaction generated automatically when copying the trades. In this situation, it needs to be assessed whether a service would still constitute portfolio management whether it could qualify as investment advice based, amongst others, on the level of the client interaction. If the client, by means of example, has a time limit to approve, modify or cancel the transaction and after the passing of the time limit the transaction is executed, then this does not mean that the interference of the client is necessary for the transaction to take place. Hence, since the trade is carried without any necessary intervention by the client, a portfolio management service is provided by the firm. Another example in which the service would likely qualify as portfolio management, is when the transactions are executed automatically even if clients still have the possibility to give specific instructions to the firm (for example, regarding leverage limits, stop-loss instructions or closing of open positions). Hence, it is important to assess and qualify the investment services provided on a case-by-case basis, and take different elements into account.

34. Relevant legislation and ESMA guidance: Articles 4(1)(4), 4(1)(5) and 4(1)(8) of MiFID II, and all relevant conduct of business and organisational requirements set in MiFID II and in the MiFID II Delegated Regulation; ESMA/2012/382 Q&A 9: '*Article 4(1)(9) of MiFID – Automatic execution of trade signals (22 June 2012)*'.

### Questions<sup>26</sup>

To determine whether the service qualifies as portfolio management or investment advice:

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<sup>25</sup> It is reminded that in this case the first firm that is receiving and transmitting the orders, must comply with Article 65 of the MiFID II Delegated Regulation when selecting the second firm for the execution of the orders.

<sup>26</sup> The questions listed throughout this supervisory briefing are examples of questions relevant to ask when looking at copy trading services specifically. Therefore, the questions listed may not be exhaustive to assess full compliance of the firms with all MiFID II Requirements.

- Does the firm manage a portfolio and execute its transactions? Is there an agreed mandate between the client and the firm which gives the firm discretion in executing transactions?
- Who takes the investment decision? The firm should explain the operational process that leads to create a transaction in order to determine whether:
  - The client does or does not confirm every transaction sent for their own account; or
  - The investment firm or another entity takes the investment decision on behalf of the client.

35. When a client decides to follow and therefore “copy” the trading activity of the copied trader, the copied trader’s trading activity generates the trading signals that are messages containing the characteristics of the last transaction sent or executed by the copied trader. It will need to be assessed on a case-by-case basis as to whether this would qualify as investment advice.

36. According to the choice of copy trading service offered to/chosen by the client, the so-generated trading signals can be instantly:

- Transmitted to the client as a personal recommendation/suggestion of transaction; or
- Converted by the firm as transactions automatically sent without the confirmation of the client. In this case, the firm would be considered as providing a portfolio management service.

37. As the industry is highly tech-oriented and innovative, other types of business models or schemes could exist.

### Questions

If the service qualifies as portfolio management:

- Does the firm providing portfolio management services have in place relevant portfolio management contracts (the mandate to execute on behalf of the client)?
  - Does the mandate include the types of instruments for example and risks such as concentration risk?
- Can the firm show and demonstrate that it has controls in place to ensure the copied trades remain within the limits of the client’s mandate?

- Does the firm have in place policies and procedures for the reporting requirements under Article 60 of the MiFID II Delegated Regulation?

If the service qualifies as investment advice:

- Can the firm demonstrate that the client actively intervenes and authorises/instructs the transactions before their transmissions/executions, as set out in the 2012 ESMA Q&A 9? For example, an ex-ante bulk approval (a blank check) or stop loss limit orders are not considered interventions on a transaction basis.
- Do the clients who are copying trades (from the copied traders), receive, for example, personal messages including recommendations for them in relation to specific investment decisions or instruments from the copied traders? In such cases, the copied traders or entity providing the personal recommendations might be seen as providing investment advice.

Qualification of RTO/Execution of orders:

- Can the firm demonstrate that it only acts upon a purchase or sale order of the client? And that, therefore, there is no operational mandate in place with regard to the provision of trade signals between the firm and the client.

Possible types of contracts in place between signal providers and investment firm:

- Does the outsourcing arrangement between the firm and the signal provider comply with the outsourcing requirements?
  - For example, are the respective rights and obligations between the parties clearly allocated?
- What is the legal status of the party to which (part of) the service is being outsourced? For example, is (part of) the service being outsourced to an authorised firm (if applicable)?

## **2.3 Information requirements: marketing and costs and charges**

38. When providing an investment service, firms need to comply with several disclosure requirements. In this section, guidance is provided with regard to assessing the compliance with requirements on marketing and the costs and charges requirements specifically.

### 2.3.1 General information requirements including marketing

39. As follows from Articles 24(3) and (4) of MiFID II and Articles 44 to 48 of the MiFID II Delegated Regulation: “*All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading*”. Considering the wide scope of the articles, this includes information and marketing communications regarding copy trading.

40. Firms should therefore ensure compliance with the following requirements (among others):

- i. Provide up-to-date and relevant information;
- ii. Provide balanced information: when referring to any potential benefits of the copy trading service, firms should also give a fair and prominent indication of any relevant risks;
- iii. Provide information that is understood by the targeted clients.

41. Relevant legislation and ESMA guidance: Article 24(3) of MiFID II; Articles 44 to 48 of the MiFID II Delegated Regulation, CESR MiFID Supervisory Briefing *Information and reporting to clients*, and if applicable the PRIIPs Regulation.

#### Questions on general information requirements including marketing:

- Does the firm provide clear information on the service provided and the consequences in terms of risks for investors?
- Does the firm comply with the information requirements about the firm and its services, the financial instruments and proposed investment strategies, and execution venues?
- Does the investment firm have procedures and processes in place to ensure that all communications linked to the copy trading service, included marketing communications, are “fair, clear and not misleading” and that the potential benefits developed in marketing communications are given the same prominence as the associated risks?
- Does the firm show information on past performance? If so, does this information provide a fair representation? For example, the information on past performance should not be the most prominent element of the communication, and it should include performance information which covers the preceding 5 years (or less if the service has been provided for less than five years as long as that information is based on a complete 12-month period). Does the firm provide clear and understandable information on the method used to calculate and present information on past performance?

- Does the firm show information on future performance? If so, is this information based on reasonable assumptions supported by objective data? Does the firm ensure that the information is not based on or refer to simulated past performance? And where the information is based on gross performance, does the firm disclose the effects of commissions, fees or other charges? Furthermore, does the firm include a prominent warning that the future forecasts are not a reliable indicator of future performance?
- If required, does the firm provide regulatory information documents such as the Key Information Document (KID) in good time to retail clients?
- In the case the copy trading service is being outsourced, are there arrangements in place stating the responsibilities regarding the provision of information to the client (as appropriate)?

### 2.3.2 Costs and charges disclosures

42. Articles 24(4) of MiFID II and 50 of the MiFID II Delegated Regulation require firms to inform retail clients on all costs and charges related to the investment service(s) provided and the financial instrument(s) involved on an ex-ante basis (i.e., in good time) and, if conditions of Article 50(9) of the MiFID II Delegated Regulation are met, on an ex-post basis.

43. When firms provide copy trading services to retail clients that qualify as portfolio management, no cost disclosure is due in relation to each investment decision taken by the firm<sup>27</sup>. However, ex-ante information about costs and charges should be provided before the firm starts providing the service, taking into account the value of the assets under discretionary management and the anticipated transactions.

44. When firms provide copy trading services that qualify as investment advice, potential costs and charges related to the provision of the investment advice service should be disclosed prior to providing such service. If an investment advice service is provided in relation to each transaction executed by the copied trader, the advice should contain information about all costs and charges related to the potential execution of the copied transaction by the client (prior to the execution)<sup>28</sup>.

45. When the firms are involved in the provision of copy trading services and their part of the provided service can be qualified as an executing service (RTO or execution of orders),

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<sup>27</sup> Reference is made to Article 50 of the MiFID II Delegated Regulation. Additional guidance about ex-ante costs and charges requirements are presented in Q&A 9.24 of ESMA Q&A on investor protection topics (ESMA Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics)

<sup>28</sup> Reference is made to Article 50 of the MiFID II Delegated Regulation. Additional guidance about costs and charges requirements are presented in Q&A 9.34 of ESMA Q&A on investor protection topics. This Q&A is applicable if the firm is also providing execution/RTO services to the retail client: the Q&A, tackles the specific situation of simultaneous provision of investment advice and execution/RTO services by the firm.

information on costs and charges should be provided to retail clients in good time before each transaction, unless there are no product costs for the relevant financial instrument<sup>29</sup>.

46. Relevant legislation and ESMA guidance: Article 24(4) of MiFID II, Article 50 of the MiFID II Delegated Regulation, especially Q&A numbers 9.22, 9.23, 9.24 and 9.34 of ESMA Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics.

#### Costs and charges questions:

- Does the investment firm have procedures and processes in place to ensure that costs and charges requirements are complied with?
- If the copied trades are related to financial instruments without product costs and the investment firm provides to the client tariff grids: are tariffs grids sufficiently granular, clear, understandable and updated?<sup>30</sup>
- If the copied trades are related to financial instruments with product costs, how does the investment firm fulfil the requirement to provide the information on costs and charges in due time, before executing the transactions?

## 2.4 Product governance requirements

47. Article 16(3) of MiFID II sets out the product governance requirements for both firms that are manufacturers of financial instruments and the distributors thereof. In line with the product governance requirements, a target market has to be defined and the distribution strategy should be consistent with the defined target market (in accordance with Article 16(3) of MiFID II). The application of the product governance requirements is proportionate, depending on the qualification of the investment service provided by the firm in question and the type of financial instrument(s) involved. For instance, if the firm is only providing RTO, the application of product governance requirements is different from the application of these requirements by a firm that provides portfolio management and/or investment advice.

48. As set out in paragraph 56 of the Guidelines on MiFID II product governance requirements<sup>31</sup> “*products should not be distributed under non-advised sales if the distributor cannot reasonably expect (i.e., ex ante) that the distribution strategy for the product (including its marketing and information strategy) will generally enable the product to reach the identified target market*”. Therefore, firms providing copy trading services are required to verify that the investment service provided to their clients will generally enable the product to reach the

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<sup>29</sup> as detailed in Q&A 9.22 and 9.23 of ESMA Q&A on investor protection topics [esma35-43-349\\_mifid\\_ii\\_qas\\_on\\_investor\\_protection\\_topics.pdf \(europa.eu\)](https://www.esma.europa.eu/press-news/esma-news/esma35-43-349-mifid-ii-qas-on-investor-protection-topics)

<sup>30</sup> Q&A 9.23 of the ESMA Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics

<sup>31</sup> Final report Guidelines on MiFID II product governance requirements ESMA35-43-3448

identified target market. The copy trading service and possible risks associated with the service require a certain level of knowledge and client awareness, hence clear information to the clients on its content and underlying risks is a key element.

49. Copy trading services can be regarded as a manner to distribute financial instruments (distribution strategy). Hence, the peculiar features of 'copy trading' should be duly taken into account by distributors when refining the manufacturers distribution strategy for the products and to define their own distribution strategy in light of information on their client base and the type of services provided. Providing investment advice, adopting a portfolio approach, or portfolio management services does not exempt the firm from defining a target market (See '*Distribution strategy of the distributor*' and '*Portfolio management, portfolio approach, hedging and diversification*' of the Guidelines on MiFID II product governance requirements).

50. Relevant legislation and ESMA guidance: Articles 16(3) and 24 (2) of MiFID II, Articles 9 and 10 of the MiFID II Commission Delegated Directive, and the Guidelines on MiFID II product governance requirements.

### Questions

- When copy trading is offered to its clients, how does the firm ensure that target markets are defined prior to providing the investment service?
- When copy trading is offered to its client, how does the firm ensure that the intended distribution strategy and the defined target market is consistent with the needs, characteristics, and objectives of target clients?
- How does the firm, providing copy trading services, ensure that investment products and services are reviewed on a regular basis, taking into account events that could materially affect the potential risk to the identified target market, and thus evaluate as to whether the distribution strategy of copy trading remains appropriate?

## **2.5 Suitability and appropriateness requirements**

51. It remains important to look on a case-by-case basis at the qualification of the service and relationship in place between the firm and copied traders, and the client and firm. If the service qualifies as investment advice or portfolio management, the firm is responsible for ensuring compliance with the suitability requirements. If, however, the service provided, by the firm that is involved in (part of) the copy trading service, qualifies as RTO or execution of orders, appropriateness requirements can apply. When this is the case, the firm in question will need to have the adequate policies and procedures in place to perform the appropriateness assessment (as needed).

52. Relevant legislation and ESMA guidance: Article 16(2) and Articles 25(2), 25(3) and 25(6) of MiFID II, Articles 21, 54(9) and 54(11), Articles 55 and 56 of the MiFID II Delegated Regulation, the Guidelines on certain aspects of the MiFID II suitability requirements<sup>32</sup>, Guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements and the Supervisory Briefing on suitability.

### 2.5.1 Provision of investment advice or portfolio management service

53. When firms provide copy trading services which qualify as portfolio management services or investment advice, they need to comply with, amongst others, the suitability requirements. In accordance with Article 25(2) of MiFID II, firms must ensure that the specific financial instrument to be recommended or invested in, in the course of providing a portfolio management service, is suitable for the client in question and falls within their mandate.

54. This Level 1 MiFID II framework is complemented by both the MiFID II Delegated Regulation on organisational requirements and operating conditions for investment firms, more specifically Articles 54 and 55 of the MiFID II Delegated Regulation, and by the Guidelines on certain aspects of the MiFID II suitability requirements.

55. It is expected that a firm ensures compliance with the aforementioned suitability requirements. Compared to the traditional model of portfolio management service, copy trading can pose some challenges depending on the relationship between the firm and the copied trader. Thus, details on how the suitability assessment will be performed must be set out clearly including when third parties are involved in the provision of the service.

56. Indeed, copy trading may involve an outsourcing agreement with regard to outsourcing part of the investment service for example to another entity providing the signals (through their copied traders). In this case, the trader that lets their trades to be copied determines the investment strategy insofar as they decide the instruments to trade in, but (s)he will not be aware of the outcome of the suitability assessments of the firm's clients that 'follow' their trades and strategy.

57. The firm providing portfolio management services and executing the decision to trade bears the responsibility to ensure compliance with applicable MiFID II provisions, including the suitability requirements. Therefore, the firm in question will need to have adequate policies and procedures in place to perform the suitability assessment. When providing copy trading services, firms should select the copied traders, but they should also have arrangements in place to evaluate the trading activity of the copied trader and set limitations regarding the

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<sup>32</sup> Reference is made to the suitability Guidelines as included in the Final Report on Guidelines on certain aspects of the MiFID II suitability requirements published on 23 September 2022: [esma35-43-3172 final report on mifid ii guidelines on suitability.pdf \(europa.eu\)](https://www.esma.europa.eu/3172-final-report-on-mifid-ii-guidelines-on-suitability.pdf)

investment activity of the copied traders whose trades are being copied, in order to ensure that all transactions fall within the clients' mandates and suitability assessment.

58. This briefing also reminds NCAs and firms that when firms are providing investment advice, in accordance with the second subparagraph of Article 25(6) of MiFID II, the firm shall provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the knowledge and experience, financial situation, objectives and other characteristics of the retail client before the transaction is made. And when providing portfolio management or investment advice, firms are required to consider clients sustainability preferences as part of the suitability assessment.

## 2.5.2 Provision of RTO or execution of orders

59. As provided for in the examples in sections 2.1 and 2.2 of this briefing, it may be the case that the service provided by a particular firm, involved in the (partial) provision of copy trading service, can qualify as the service of RTO or execution of orders on behalf of clients. When this is the case, the firm shall comply with, amongst others, the appropriateness requirements. In accordance with Article 25(3) of MiFID II, the firms must verify if the specific investment product envisaged is appropriate for the client (except when Article 25(4) of MiFID II applies).

60. The Level 1 MiFID II framework is complemented by Articles 55 and 56 of the MiFID II Delegated Regulation and by Guidelines on appropriateness and execution-only requirements under MiFID II.

61. When transactions are copied and transmitted for execution to the firm by the client, the firm should verify, prior to executing or transmitting the order, that the financial instrument is aligned with the level of knowledge and experience of the copying client (unless the transaction meets all the conditions listed in Article 25(4) of MiFID II).

62. As mentioned in Articles 25(3) of MiFID II and Article 56(2)(b) of the MiFID II Delegated Regulation, prior to executing the order (including orders resulting from copy trading), firms should warn the client, if they consider that the product is not appropriate and, where relevant, record that the appropriateness test has been performed and that the client has been warned (if necessary).

### Questions

In the case that the copy trading service qualifies as portfolio management or investment advice:

- Can the firm demonstrate that they collect the necessary information from clients on their investment objectives (including their risk tolerance and sustainability preferences), financial situation and knowledge and experience?
- How does the firm ensure that the client's and the copied trader's risk profiles are not defined too broadly?
- Can the firm demonstrate that it monitors the copied transactions in order to ensure that the transactions remain within the client's stated risk limits?
  - How does the firm intervene when the transactions are not within the client's risk limits?
- Can the firm demonstrate that the suitability assessment, conducted prior to executing or transmitting the transaction, ensures that the types of financial instruments that the copied trader invests in are compatible with the knowledge and experience of the client copying the trades?
- Portfolio management: Can the firm demonstrate that the client's mandate to the firm to copy trades is sufficiently precise and clear, meaning that it includes for example the types of assets to be invested in and the liquidity and market risks?
- What approach does the firm adopt when assessing the features of the trades/portfolio copied from the trader to trader to comply with their suitability obligations by ensuring that the transactions is in line with the client's profile, and is this approach compliant with applicable MiFID II requirements?
- How does the firm ensure that the copied trader does not switch to other instruments that are not compatible with, for example, the knowledge and experience of the client copying the trades? Or how does the firm ensure that when a copied trader switches to unsuitable instruments, these trades are not automatically copied?
- How does the firm ensure that the applicable reporting requirements from Article 25(6) MiFID II are complied with when providing the copy trading services?
  - In the case of investment advice, does the firm provide the suitability report prior to every transaction?
- Does the firm have the (IT) arrangements in place to ensure that unsuitable transactions are not automatically copied?
- Does the firm undertake an ex-ante evaluation of the investment activity of the person whose trades become copyable?

- Does the firm set any limits or other restrictions on the trading activity of the persons whose trades become copyable, to ensure that such trades are compatible with the investment profile of clients?
- Does the firm periodically review and assess the outcome of the automated tools used (if any) when copying the trader's trades?
- Does the firm consider clients sustainability preferences as part of the suitability assessment?
- Investment advice: Is the suitability statement (that needs to be submitted prior to the transaction is made) submitted to the clients in due time by the firm or the copied trader when the recommendation is made?
- Investment advice: How does the firm ensure that the recommendations provided to the client remain suitable in the case in which the copied traders change the type of instruments they trade in for example?

In case the service qualifies as RTO or execution of orders on behalf of clients, and the appropriateness requirements are applicable:

- How does the firm ensure compliance with the appropriateness requirements?
- How does the firm warn the client if the transaction is not appropriate and then obtain its decision to execute (or not) the transaction despite the warning (where relevant)?

## 2.6 Remuneration and inducement requirements

63. In accordance with Articles 16(3) and 23(1) of MiFID II firms are required to take reasonable steps to avoid conflicts of interest between the firms themselves and their client or between the clients of the firms. These conflicts of interest include, as stated in Article 23(1) of MiFID II, conflicts of interest resulting from the firm's inducements or remuneration structures or received of paid inducements (see also Article 24(9) b of MiFID II). Such conflicts of interest, in the case of copy trading services, can arise in particular from the structure of the payment made to the traders whose trades are being copied and from the fact that the copied traders, in many cases, may also be clients of such investment firms. Therefore, in this example, the copied trader could be paying the firm as a client and be receiving remuneration for maintaining and sharing the trades with the investment firm for other clients to copy.

64. When offering copy trading services, different arrangements between the firm and the copied trader might be in place. The remuneration of copied traders, who are not considered to be employees of the firm, can nonetheless need to comply with the MiFID II remuneration requirements because copied traders may be:

- i. a natural person whose services are placed at the disposal and under the control of the firm or a tied agent of the firm and who is involved in the provision by the firm of investment services and activities<sup>33</sup>; or
- ii. a natural person who is directly involved in the provision of services to the firm or to its tied agent under an outsourcing arrangement for the purpose of the provision by the firm of investment services and activities<sup>34</sup>,

65. In both situations, the MiFID II remuneration requirements and the Guidelines on certain aspects of the MiFID II remuneration Requirements should be complied with.<sup>35</sup>

66. When a copied trader (signal provider) would not fall under Article 2(1)(c) nor (d) of the MiFID II Delegated Regulation, remuneration requirements would not directly apply. However, in that case, the general duty of the firm to avoid, manage and disclose conflicts of interest would still apply. Some of the arrangements in place by firms could neither technically fall under an employment contract nor constitute an outsourcing agreement because the copied traders in question are clients of the firm and they share their traders for others to copy on the basis of a commercial contract with the firm.

67. Irrespective of the contract in place, the firm shall ensure compliance with MiFID II provisions safeguarding the best interest of their clients receiving an investment service.

68. There can be possible models in which firms have a commissions-based system in place for the copied traders and these payments may therefore be considered as 'inducements' in the context of the provision of investment service (RTO, execution of orders, investment advice or portfolio management) to the 'copying' client. In this case, firms should pay specific attention to the requirements mentioned in Article 24(9) and, if so Article 24(8) of MiFID II and the firms should ensure that all conditions mentioned in the relevant paragraphs of Article 24 of MiFID II and Article 11 of MiFID II Delegated Directive are met.

69. Relevant legislation and ESMA guidance: Article 16(3), Article 23(1), Article 24(1), (7), (8) and (9) of MiFID II, Article 2(1)(c) and 2(1)(d), Articles 21, 28, 29, 33 and Article 40(3) of the MiFID II Delegated Regulation, Article 11 MiFID II Delegated Directive and the remuneration guidelines.

## Questions

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<sup>33</sup> Article 2(1)(c) of the MiFID II Delegated Regulation

<sup>34</sup> Article 2(1)(d) of the MiFID II Delegated Regulation

<sup>35</sup> the Final Report of the Guidelines on certain aspects of the MiFID II remuneration requirements [ESMA35-36-2537].  
[https://www.esma.europa.eu/system/files\\_force/library/esma\\_35-36-2537\\_final\\_report\\_on\\_guidelines\\_on\\_certain\\_aspects\\_of\\_the\\_mifid\\_ii\\_requirements.pdf?download=1](https://www.esma.europa.eu/system/files_force/library/esma_35-36-2537_final_report_on_guidelines_on_certain_aspects_of_the_mifid_ii_requirements.pdf?download=1)

- Does the investment firm have in place a relevant contract between the firm and the copied trader?

Where the MiFID II remuneration requirements apply:

- Does the firm have a remuneration policy in place with regard to remuneration paid to copied traders?
- What criteria are used to determine the variable remuneration paid to copied traders? Are, for example, any of the following examples in place:
  - Number and value of trades copied;
  - Number of followers of their strategy;
  - Performance of the average AUM?
- Are the firm's remuneration policies designed in such way so as to not create incentives that may lead relevant persons to favour their own interest?
- Do the firm's remuneration policies and practices define appropriate criteria used to align the interests of the relevant persons, in this case the copied traders, and that of the clients?
- Do the remuneration policies and practices include qualitative criteria that encourage these relevant persons to act in the best interests of the client?
- Is the remuneration of the copied trader partially or fully variable?
- What type of remuneration is paid to the copied trader (only monetary or also non-monetary)?
- (If relevant) is the remuneration of copied traders different depending on whether the firm automatically copy and executes similar trades or, instead, the client decides whether or not to copy the trade?

If copied traders are recognised as relevant persons:

- Does the investment firm have necessary procedures regarding the copied traders involvement in the investment firms activities?
- Does the investment service provider have arrangements in place to cover the personal transactions obligations that apply to the relevant persons?

- In case of outsourcing, does the investment firm outsourcing the activities supervise the copied traders and require them to follow the relevant internal procedures?

Where MiFID II remuneration requirements do not apply, for example because the copied trader is a third party, and inducements requirements apply:

- Does the investment service provider have arrangements in place to determine in which cases payments to copied traders should be considered as inducements?
- How does the firm ensure compliance with the inducement requirements?
- In particular, how does the investment service provider inform the 'copying' client about inducements paid to the copied trader?
- How does the firm justify the provision of an additional or higher-level service to 'copying' client proportional to the inducement paid?

## 2.7 Qualifications of copied traders

70. Article 25(1) of MiFID II states that Member States shall require firms to ensure and demonstrate that natural persons giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the firm possess the necessary knowledge and competence to fulfil their obligations under Article 24 and Article 25 of MiFID II. As to whether a copied trader would fall under scope of Article 25(1) of MiFID II needs to be assessed on a case-by-case basis.

71. That being said, as established previously in this briefing, copy trading services provided by firms are likely to either fall under portfolio management or investment advice, depending on the circumstances. Given this determination, this would mean that copied traders would need to have the required knowledge and competence for either of these services provided and that the firms in question should have in place relevant procedures to ensure that the copied traders comply with the qualification requirements. In accordance with Article 21(1)(d) of the MiFID II Delegated Regulation a firm shall employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. It is therefore important to assess, for the application of this requirement, as to whether the copied traders can be considered to be employees of the firm.

72. Article 21(1)(b) and (g) of the MiFID II Delegated Regulation requires investment firms to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities, and to ensure that the performance of multiple functions by their relevant persons does not, and is not likely to, prevent those persons from discharging any particular function soundly, honestly, and professionally. Investment firms shall therefore implement the necessary procedures so that all the issues mentioned in the

article are covered, also with regard to copy trading, considering the key role that copied traders can have in the provision of services to retail investors. More specifically, the firm should ensure that the copied traders act honestly, fairly and professionally. Investment firms shall, in addition, ensure that copied traders meet requirements concerning their minimum skill, trading experience or knowledge, to ensure a sound and proper provision of investment activities.

73. When provision of trade signals as a part of investment advice or portfolio management service involves outsourcing arrangements, Article 31(2)(a) of the MiFID II Delegated Regulation applies, requiring firms performing outsourced functions to have “*the ability, capacity, sufficient resources, appropriate organisational structure supporting the performance of the outsourced functions, and any authorisation required by law to perform the outsourced functions, reliably and professionally.*” Moreover, in such case, the firm that outsources its activities and the firm actually performing such activities shall ensure that copied traders who share their trades(signals), fulfil all the necessary obligations described above since they also may be considered as ‘relevant persons’ under the MiFID II Delegated Regulation.

74. Considering that “copied traders” often present themselves as having financial expertise and/or experience and put forward their investment recommendations in such a way that other persons would reasonably believe they have financial expertise or experience, they could, in these cases, be considered as “experts” within the meaning of Article 1(a) of the Market Abuse Delegated Regulation<sup>36</sup>. As such, in addition to the general obligations for those who put forward investment recommendations, they would be subject to additional requirements, for example those regarding “disclosure of interests or of conflicts of interest” as per Article 6 of MAR DR.

75. Relevant legislation and ESMA guidance: Article 25(1) and (9) of MiFID II, the ESMA Guidelines for the assessment of knowledge and competence. Articles 16(2) and 16(5) first subparagraph of MiFID II and Article 21(1)(b), (d) and (g) and Articles 30, 31 and 36(2) of the MiFID II Delegated Regulation and Article 20(1) of MAR and Articles 1(a) and 5 of the MAR Delegated Regulation.

### Questions

- Does the investment firm have procedures in place to ensure that the copied traders perform their services in accordance with the obligations (requirements) applicable to the investment firm?

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<sup>36</sup> Commission Delegated Regulation (EU) 2016/958 of 9 March 2016 supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the technical arrangements for objective presentation of investment recommendations or other information recommending or suggesting an investment strategy and for disclosure of particular interests or indications of conflicts of interest

- Does the investment firm have procedures and processes in place to ensure that the copied trader provides the required information related to their interests and conflicts of interests as expected under Article 20(1) of MAR and Article 6 of MAR DR?

In case copied traders fall under the scope of Article 25(1) of MiFID II:

- Does the firm have the necessary policies and procedures in place ensuring that the copied traders possess and maintain the necessary knowledge and competence to meet relevant regulatory and legal requirements, business ethics standards and to fulfil their obligations reflecting the scope and degree of the service provided?
- Do the copied traders have the necessary skills to assess the needs and circumstances of the client?
- Do the copied traders have sufficient expertise in financial markets to understand the financial instruments that they recommend or provide information on and, where relevant, are they able to determine that the features of the instrument match the needs and circumstances of the client?

In case copy trading services are outsourced:

- Does the service provider have the ability to perform the service in a reliable and professional manner?
- Does the investment firm have procedures and processes in place to take the necessary steps to ensure that the outsourced copy trading service provider has the ability, capacity and sufficient resources to provide the service?
- Do both the investment firm and the service provider ensure that the signal providers (copied traders) who are considered 'relevant persons' are aware of and act in accordance with the investment firm's procedures?