European Securities and Markets Authority

Guidelines

Guidelines on certain aspects of the MiFID suitability requirements

21 August 2012 | ESMA/2012/387

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Contents

I. Scope

Who?

1. These guidelines apply to investment firms (as defined in Article 4(1)(1) of MiFID), including credit institutions that provide investment services, UCITS management companies[1], and competent authorities.

What?

2. These guidelines apply in relation to the provision of the following investment services listed in Section A of Annex I of the Markets in Financial Instruments Directive (MiFID):

   (a) investment advice;

   (b) portfolio management.

3. Although these guidelines principally address situations where services are provided to retail clients, they should also be considered as applicable, to the extent they are relevant, when services are provided to professional clients (MiFID Article 19(4) makes no distinction between retail and professional clients).

When?

4. These guidelines apply from 60 calendar days after the reporting requirement date referred to in paragraph 11.

II. Definitions

5. Unless otherwise specified, terms used in the Markets in Financial Instruments Directive and the MiFID Implementing Directive have the same meaning in these guidelines. In addition, the following definitions apply:

Markets in Financial Instruments Directive (MiFID)	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, as subsequently amended.
MiFID Implementing Directive	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

6. Guidelines do not reflect absolute obligations. For this reason, the word 'should' is often used. However, the words 'must' or 'are required' are used when describing a MiFID requirement.

[1] These guidelines only apply to UCITS management companies when they are providing the investment services of individual portfolio management or of investment advice (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive).

III. Purpose

7. The purpose of these guidelines is to clarify the application of certain aspects of the MiFID suitability requirements in order to ensure the common, uniform and consistent application of Article 19(4) of MiFID and of Articles 35 and 37 of the MiFID Implementing Directive.

8. ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID suitability requirements, by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.

IV. Compliance and reporting obligations

Status of the guidelines

9. This document contains guidelines issued under Article 16 of the ESMA Regulation.[2] In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants shall make every effort to comply with guidelines.

10. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

Reporting requirements

11. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for any non-compliance. Competent authorities must notify ESMA within two months of publication of the translations by ESMA to '**suitability.387@esma.europa.eu**'. In the absence of a response by this deadline, competent authorities will be considered non-compliant. A template for notifications is available on the ESMA website.

12. Financial market participants are not required to report whether they comply with these guidelines.

V. Guidelines on certain aspects of the MiFID suitability requirements

V.I Information to clients about the suitability assessment

Relevant legislation: Article 19(1) and (3) of MiFID.

General guideline 1

13. Investment firms should inform clients, clearly and simply, that the reason for assessing suitability is to enable the firm to act in the client's best interest. At no stage should investment firms create any ambiguity or confusion about their own responsibilities in the process.

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[2] 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.

Supporting guidelines

14. Information on investment advice and portfolio management services should include information about the suitability assessment. 'Suitability assessment' should be understood as meaning the whole process of collecting information about a client, and the subsequent assessment of the suitability of a given financial instrument for that client.

15. For the sake of clarity, firms are reminded that the suitability assessment is not limited to recommendations to buy a financial instrument. Every recommendation must be suitable, whether it is a recommendation to buy, hold or sell, for example.[3] Information about the suitability assessment should help clients to understand the purpose of the requirements and should encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation and investment objectives. Investment firms should highlight to the client that it is important to gather complete and accurate information so that the firm can recommend suitable products or services for the client. It is up to the firms to decide how they will inform their clients about the suitability assessment and such information can be provided in a standardised format. The format used should however enable *a posteriori* controls to check if the information was provided.

16. Investment firms should take steps to ensure that the client understands the notion of investment risk as well as the relationship between risk and return on investments. To enable the client's understanding of investment risk, firms should consider using indicative, comprehensible examples of the levels of loss that may arise depending on the level of risk taken, and should assess the client's response to such scenarios. The client should be made aware that the purpose of such examples, and their responses to them, is to help determine the client's attitude to risk (their risk profile), and therefore the types of financial instruments (and risks attached to them) that are suitable.

17. The suitability assessment is the responsibility of the investment firm. Firms should avoid stating or giving the impression that it is the client who decides on the suitability of the investment, or that it is the client who establishes which financial instruments fit his own risk profile. For example, firms should avoid indicating to the client that a certain financial instrument is the one that the client chose as being suitable, or requiring the client to confirm that an instrument or service is suitable.

V.II **Arrangements necessary to understand clients and investments**

Relevant legislation: Articles 13(2) and 19(4) of MiFID, and Articles 35(1) and 37 of the MiFID Implementing Directive.

General guideline 2

18. Investment firms must have in place adequate policies and procedures to enable them to understand the essential facts about their clients and the characteristics of the financial instruments available for those clients.[4]

Supporting guidelines

[3] See section IV of CESR, Understanding the definition of advice under MiFID, question and answers, 19 April 2010, CESR/10-293.
[4] Adequate records about the suitability assessment should also be kept, as illustrated in guideline 9.

19. Investment firms are required to establish, implement and maintain all policies and procedures (including appropriate tools) necessary to be able to understand those essential facts and characteristics.[5]

20. Firms must implement policies and procedures that enable them to collect and assess all information necessary to conduct a suitability assessment for each client. For example firms could use questionnaires completed by their clients or during discussions with them.

21. Information necessary to conduct a suitability assessment includes different elements that may impact, for example, the client's financial situation or investment objectives.

22. Examples of such elements are the client's:

    (a) marital status (especially the client's legal capacity to commit assets that may belong also to his partner);

    (b) family situation (evolutions in the family situation of a client may impact his financial situation e.g. a new child or a child of an age to start university);

    (c) employment situation (the fact for a client to lose his job or to be close to retirement may impact his financial situation or his investment objectives);

    (d) need for liquidity in certain relevant investments.

23. The client's age, especially, is usually important information firms should be aware of to assess the suitability of an investment. When determining what information is necessary, firms should keep in mind the impact that any change regarding that information could have concerning the suitability assessment.

24. Investment firms should also know the products they are offering. This means that firms should implement policies and procedures designed to ensure that they only recommend investments, or make investments on behalf of their clients, if the firm understands the characteristics of the product, or financial instrument, involved.

V.III Qualifications of investment firm staff

Relevant legislation: Article 5(1)(d) of the MiFID Implementing Directive.

General guideline 3

25. Investment firms are required to ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise.[6]

Supporting guidelines

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[5] Article 13(2) of MiFID.

[6] Article 5(1)(d) of the MiFID Implementing Directive requires all investment firms to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

26. Staff must understand the role they play in the suitability assessment process and possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulatory requirements and procedures, to discharge their responsibilities.

27. Staff must have the skills necessary to be able to assess the needs and circumstances of the client. They are also required to have sufficient expertise in financial markets to understand the financial instruments to be recommended (or purchased on the client's behalf), and to determine that the features of the instrument match the needs and circumstances of the client.

28. ESMA notes that some Member States require certification of staff providing investment advice and/or portfolio management, or equivalent systems, to ensure a proper level of knowledge and expertise of staff involved in material aspects of the suitability process.

V.IV Extent of information to be collected from clients (proportionality)

Relevant legislation: Article 19(4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.

General guideline 4

29. Investment firms should determine the extent of information to be collected from clients in light of all the features of the investment advice or portfolio management services to be provided to those clients.

Supporting guidelines

30. Before providing investment advice or portfolio management services, investment firms will always need to collect 'necessary information' about the client's knowledge and experience, financial situation and investment objectives.

31. The extent of information collected may vary. In determining what information is 'necessary' and relevant, investment firms should consider, in relation to a client's knowledge and experience, financial situation and investment objectives:

    (a) the type of the financial instrument or transaction that the firm may recommend or enter into (including the complexity and level of risk);

    (b) the nature and extent of the service that the firm may provide;

    (c) the nature, needs and circumstances of the client.

32. While the extent of the information to be collected may vary, the standard for ensuring that a recommendation or an investment made on the client's behalf is suitable for the client will always remain the same. The principle of proportionality in MiFID allows firms to collect the level of information proportionate to the products and services they offer, or on which the client requests specific investment advice or portfolio management services. It does not allow firms to lower the level of protection due to clients.

33. For example, when providing access to complex[7] or risky[8] financial instruments, investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex or risky instruments are at stake. This is so firms can assess the client's capacity to understand, and financially bear, the risks associated with such instruments.[9]

34. For illiquid financial instruments[10], the 'necessary information' to be gathered will obviously include information on the length of time for which the client is prepared to hold the investment. As information about a client's financial situation will always need to be collected, the extent of information to be collected may depend on the type of financial instruments to be recommended or entered into. For example, for illiquid or risky financial instruments, 'necessary information' to be collected may include all of the following elements as necessary to ensure whether the client's financial situation allows him to invest or be invested in such instruments:

    (a) the extent of the client's regular income and total income, whether the income is earned on a permanent or temporary basis, and the source of this income (for example, from employment, retirement income, investment income, rental yields, etc);

    (b) the client's assets, including liquid assets, investments and real property, which would include what financial investments, personal and investment property, pension funds and any cash deposits, etc. the client may have. The firm should, where relevant, also gather information about conditions, terms, access, loans, guarantees and other restrictions, if applicable, to the above assets that may exist;

    (c) the client's regular financial commitments, which would include what financial commitments the client has made or is planning to make (client's debits, total amount of indebtedness and other periodic commitments, etc).

35. In determining the information to be collected, investment firms should also take into account the nature of the service to be provided. Practically, this means that:

    (a) when investment advice services are to be provided, firms should collect sufficient information in order to be able to assess the ability of the client to understand the risks and nature of each of the financial instruments that the firm envisages recommending to that client;

    (b) when portfolio management services are to be provided, as investment decisions are to be made by the firm on behalf of the client, the level of knowledge and experience needed by the client with regard to all the financial instruments that can potentially make up the portfolio may be less detailed than the level that the client should have when an investment advice service is to be provided. Nevertheless, even in such situations, the client

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[7] As defined in MiFID.
[8] It is up to each investment firm to define *a priori* the level of risk of the financial instruments included in its offer to investors taking into account, where available, possible guidelines issued by competent authorities supervising the firm.
[9] In any case, to ensure clients understand the investment risk and potential losses they may bear, the firm should, as far as possible, present these risks in a clear and understandable way, potentially using illustrative examples of the extent of loss in the event of an investment performing badly. A client's ability to accept losses may be aided by measuring the loss-sustaining capacity of the client. See also paragraph 16.
[10] It is up to each investment firm to define *a priori* which of the financial instruments included in its offer to investors it considers as being illiquid, taking into account, where available, possible guidelines issued by competent authorities supervising the firm.

should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio. Firms should gain a very clear understanding and knowledge of the investment profile of the client.

36. Similarly, the extent of the service requested by the client may also impact the level of detail collected about the client. For example, firms should collect more information about clients asking for investment advice covering their entire financial portfolio than about clients asking for specific advice on how to invest a given amount of money that represents a relatively small part of their overall portfolio.

37. An investment firm should also take into account the nature of the client when determining the information to be collected. For example, more in-depth information would usually need to be collected for older and potentially vulnerable clients asking for investment advice services for the first time. Also, where a firm provides investment advice or portfolio management services to a professional client (who has been correctly classified as such), it is generally entitled to assume that the client has the necessary level of experience and knowledge, and therefore is not required to obtain information on these points.

38. Similarly, where the investment service consists of the provision of investment advice or portfolio management to a 'per se professional client'[11] the firm is entitled to assume that the client is able to financially bear any related investment risks consistent with the investment objectives of that client and therefore is not generally required to obtain information on the financial situation of the client. Such information should be obtained, however, where the client's investment objectives demand it. For example, where the client is seeking to hedge a risk, the firm will need to have detailed information on that risk in order to be able to propose an effective hedging instrument.

39. Information to be collected will also depend on the needs and circumstances of the client. For example, a firm is likely to need more detailed information about the client's financial situation where the client's investment objectives are multiple and/or long-term, than when the client seeks a short-term secure investment.

40. If an investment firm does not obtain sufficient information[12] to provide an investment advice or portfolio management service that is suitable for the client, it must not provide such service to that client.[13]

V.V Reliability of client information

Relevant legislation: Article 19(4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.

General guideline 5

41. Investment firms should take reasonable steps to ensure that the information collected about clients is reliable. In particular, firms should:

[11] As set out in Section I of Annex II of MiFID ('Categories of client who are considered to be professionals').
[12] 'Sufficient information' should be understood as meaning the information that firms must collect to comply with the suitability requirements under MiFID.
[13] See Article 35(5) of the MiFID Implementing Directive.

(a) not rely unduly on clients' self-assessment in relation to knowledge, experience and financial situation;

(b) ensure that all tools employed in the suitability assessment process are appropriately designed (e.g. questions are not drafted in such a way that they lead the client to a specific type of investment); and

(c) take steps to ensure the consistency of client information.

Supporting guidelines

42. Clients are expected to provide correct, up-to-date and complete information necessary for the suitability assessment. However investment firms need to take reasonable steps to check the reliability of information collected about clients. Firms remain responsible for ensuring they have adequate information to conduct a suitability assessment. For example, firms should consider whether there are any obvious inaccuracies in the information provided by their clients. They will need to ensure that the questions they address to their clients are likely to be understood correctly and that any other method used to collect information is designed in way to get the information required for a suitability assessment.

43. Self-assessment should be counterbalanced by objective criteria. For example:

    (a) instead of asking a client whether he feels sufficiently experienced to invest in certain instruments, the firm could ask the client what types of instruments the client is familiar with;

    (b) instead of asking whether clients believe they have sufficient funds to invest, the firm could ask for factual information about the client's financial situation;

    (c) instead of asking whether a client feels comfortable with taking risk, the firm could ask what level of loss over a given time period the client would be willing to accept, either on the individual investment or on the overall portfolio.

44. Where investment firms rely on tools to be used by clients as part of the suitability process (such as on-line questionnaires, or risk-profiling software), they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. For example, risk-profiling software could include some controls of coherence of the replies provided by clients in order to highlight contradictions between different pieces of information collected.

45. Firms should also take reasonable steps to mitigate potential risks associated with the use of such tools. For example, potential risks may arise where clients (on their own initiative or where encouraged by customer-facing staff) change their answers in order to get access to financial instruments that may not be suitable for them.

46. In order to ensure the consistency of client information, investment firms should view the information collected as a whole. Firms should be alert to any relevant contradictions between different pieces of information collected, and contact the client in order to resolve any material potential inconsistencies or inaccuracies. Examples of such contradictions are clients who have little knowledge or experience and an aggressive attitude to risk, or who have a prudent risk profile and ambitious investment objectives.

V.VI Updating client information

Relevant legislation: Article 37(3) of the MiFID Implementing Directive.

General guideline 6

47. Where an investment firm has an ongoing relationship with the client, it should establish appropriate procedures in order to maintain adequate and updated information about the client.

Supporting guidelines

48. When providing investment advice on an ongoing basis or the ongoing service of portfolio management, investment firms need to maintain adequate and updated information about the client in order to be able to perform the suitability assessment required. Firms will therefore have to adopt procedures defining:

    (a) what part of the information collected should be subject to updating and at which frequency;

    (b) how the updating should be done and what action should be undertaken by the firm when additional or updated information is received or when the client fails to provide the information requested.

49. Frequency might vary depending on, for example, clients' risk profiles: based on the information collected about a client under the suitability requirements, a firm will often determine the client's investment risk profile, i.e. what type of investment services or financial instruments can in general be suitable for him taking into account his knowledge and experience, his financial situation and his investment objectives. A higher risk profile is likely to require more frequent updating than a lower risk profile. Certain events might also trigger an updating process; this could be so, for example, for clients reaching the age of retirement.

50. Updating could, for example, be carried out during periodic meetings with clients or by sending an updating questionnaire to clients. Relevant actions might include changing the client's profile based on the updated information collected.

V.VII Client information for legal entities or groups

Relevant legislation: Articles 4(1)(10) and 19(4) of MiFID.

General guideline 7

51. Where a client is a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person, to identify who should be subject to the suitability assessment, the investment firm should first rely on the applicable legal framework.

52. If the legal framework does not provide sufficient indications in this regard, and in particular where no sole representative has been appointed (as may be the case for a married couple), the investment firm, based on a policy it has defined beforehand, should agree with the relevant persons (the representatives of the legal entity, the persons belonging to the group or the natural persons represented) as to who should be subject to the suitability assessment and how this assessment will be done in practice, including from whom information about knowledge and experience, financial situation and

investment objectives, should be collected. The investment firm should make a record of the agreement.

Supporting guideline

53. MiFID Annex II states that the assessment of "expertise, experience and knowledge" required for small entities requesting to be treated as professional should be performed on "the person authorised to carry out transactions on behalf of the entity". By analogy, this approach should apply for suitability assessment purposes to cases where a natural person is represented by another natural person and where a small entity is to be considered for the suitability assessment. In these situations, the financial situation and investment objectives should be those of the underlying client (natural person who is represented or small entity), while the experience and knowledge should be those of the representative of the natural person or of the person authorised to carry out transactions on behalf of the entity.

54. Firms should set a policy on who should be subject to the suitability assessment when dealing with a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person. The firm's policy should provide that the best interests of all the persons concerned and their need for protection are taken into consideration.

55. Where there is no agreement and where the financial situations of the persons belonging to the group differ, the firm should consider the most relevant person in this respect (i.e. the person with the weakest financial situation). The same should be done when considering their investment objectives (i.e. the person with the most conservative investment objectives), or their experience and knowledge (i.e. the person authorised to carry out transactions with the least experience and knowledge).

56. In situations where two or more persons are authorised to carry out transactions on behalf of the group jointly (as may be the case for joint accounts), the client profile as defined by the firm should reflect the ability of the different relevant persons to take investment decisions, as well as the potential impact of such decisions on their individual financial situation and investment objectives.

V.VIII Arrangements necessary to ensure the suitability of an investment

Relevant legislation: Article 13(2) of MiFID, and Article 5 of the MiFID Implementing Directive.

General guideline 8

57. In order to match clients with suitable investments, investment firms should establish policies and procedures to ensure that they consistently take into account:

    (a) all available information about the client that is likely to be relevant in assessing whether an investment is suitable, including the client's current portfolio of investments (and asset allocation within that portfolio);

(b) all material characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.[14]

Supporting guidelines

58. Investment firms that rely on tools in the suitability assessment process (such as model portfolios, asset allocation software or a risk-profiling tool for potential investments), should have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results.

59. In this regard, the tools should be designed so that they take account of all the relevant specificities of each client or financial instrument. For example, tools that classify clients or financial instruments broadly would not be fit for purpose.

60. A firm should establish policies and procedures which enable it to ensure inter alia that:

    (a) the advice and portfolio management services provided to the client take account of an appropriate degree of risk diversification;

    (b) the client has an adequate understanding of the relationship between risk and return, i.e. of the necessarily low remuneration of risk free assets, of the incidence of time horizon on this relationship and of the impact of costs on his investments;

    (c) the financial situation of the client can finance the investments and the client can bear any possible losses resulting from the investments;

    (d) any personal recommendation or transaction entered into in the course of providing an investment advice or portfolio management service, where an illiquid product is involved, takes into account the length of time for which the client is prepared to hold the investment; and

    (e) any conflicts of interest are prevented from adversely affecting the quality of the suitability assessment.

V.IX **Record-keeping**

Relevant legislation: Article 13(6) of MiFID, and Articles 5(1)(f) and 51 of the MiFID Implementing Directive.

General guideline 9

61. Investment firms should at least:

    (a) maintain adequate recording and retention arrangements to ensure orderly and transparent record-keeping regarding the suitability assessment, including any investment advice provided and all investments (and disinvestments) made;

[14] See Article 33 of the MiFID Implementing Directive regarding the obligation to inform clients about costs.

(b) ensure that record-keeping arrangements are designed to enable the detection of failures regarding the suitability assessment (such as mis-selling);

(c) ensure that records kept are accessible for the relevant persons in the firm, and for competent authorities;

(d) have adequate processes to mitigate any shortcomings or limitations of the record-keeping arrangements.

Supporting guidelines

62. Record-keeping arrangements adopted by investment firms must be designed to enable firms to track ex-post why an investment was made. This could be important in the event of a dispute between a client and the firm. It is also important for control purposes - for example, any failures in record-keeping may hamper a competent authority's assessment of the quality of a firm's suitability process, and may weaken the ability of management information to identify risks of mis-selling.

63. Therefore, an investment firm is required to record all relevant information about the suitability assessment, such as information about the client (including how that information is used and interpreted to define the client's risk profile), and information about financial instruments recommended to the client or purchased on the client's behalf. Those records should include:

(a) any changes made by the firm regarding the suitability assessment, in particular any change to the client's investment risk profile;

(b) the types of financial instruments that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them.