esma European Securities and Markets Authority

MiFID Supervisory Briefing

Appropriateness and execution-only

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European Securities and Markets Authority

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I. Background

1. ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices.

2. This supervisory briefing has been designed for supervisors as an accessible introduction to the Markets in Financial Instruments Directive (MiFID)[1] appropriateness rules, and as a useful starting point when deciding on areas of supervisory focus. It summarises the key elements of the rules and explains the associated objectives and outcomes. It also includes indicative questions that supervisors could ask themselves, or a firm, when assessing firms' approaches to the application of the MiFID rules.

3. The content of this briefing is not exhaustive, does not constitute new policy, and does not promote any particular way of supervising the rules. It has been designed to be used in the way that best fits with supervisors' methodologies (whether distributing the briefings internally, or passing them to external bodies, such as auditors, for example).

II. Scope

4. This supervisory briefing explains the MiFID appropriateness test and is aimed at *competent authorities* (as defined in MiFID). It is also meant to give market participants indications of compliant implementation and application of the relevant MiFID provisions.

5. It takes account of related CESR work[2] and the European Commission's database of MiFID 'Questions and Answers'.

6. It applies in relation to the application of the following MiFID provisions:

   - Articles 19(5) and (6) of MiFID (2004/39/EC).

   - Articles 36-38 of the MiFID Implementing Directive (2006/73/EC).[3]

III. Status of this document

7. This document is issued in terms of Article 29 of the ESMA Regulation.[4]

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[1] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.
[2] In November 2009, CESR published the conclusions of its consultation exercise on the distinction between complex and non-complex financial instruments for the purpose of the MiFID appropriateness test - including an indicative list of how commonly traded instruments should (in CESR's view) be treated. The relevant documents are http://www.cesr.eu/popup2.php?id=6157 and http://www.cesr.eu/popup2.php?id=6158.
[3] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council.

IV. Briefing

IV.I. Appropriateness

8. The current MiFID appropriateness requirements are set out in Articles 19(5) and (6) of MiFID (2004/39/EC) and in Articles 36-38 of the MiFID Implementing Directive (2006/73/EC). Article 19(6) of MiFID and Article 38 of the MiFID Implementing Directive cover the 'execution-only' element of the appropriateness regime. The aim of the requirements is to increase investor protection in respect of 'non-advised' services.

9. The way in which the requirements apply depends on the type of service in question, the type of MiFID financial instrument involved (in particular, whether the product is 'complex' or 'non-complex'), and the type of client.

10. They apply to firms which provide MiFID investment services other than investment advice or portfolio management (in those cases, the obligation is to assess suitability). Therefore, they apply to firms when performing 'non-advised services' such as receiving or transmitting orders, executing orders on behalf of clients, dealing on own account, underwriting, and placing.

11. The requirements do not apply to eligible counterparties. In addition, firms may assume that a professional client has the necessary knowledge and experience to understand the risks involved relating to the specific product or service for which they are classified as 'professional'.

12. Where the appropriateness test applies, it requires an investment firm to seek information from a client or potential client about his knowledge and experience (i.e. ability) to understand the risks about a specific type of product or service. This is to enable the firm to determine whether that product or service is appropriate for the client. (Unlike the requirements for suitability, there are no specific requirements to assess the client's financial situation or investment objectives).

IV.II. Execution-only business

13. In MiFID Article 19(6) (together with Article 38 of the MiFID Implementing Directive), there is an exemption from the appropriateness test for certain types of 'execution-only' business. However, this is currently only available if all of the following conditions are met:

    a. the service consists only of the execution and/or the reception and transmission of orders involving shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or other securitised debt that embed a derivative), UCITS and other non-complex financial instruments; and

    b. the service is provided 'at the initiative of the client or potential client'; and

    c. the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the financial instrument or

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[4] 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.

service provided or offered, and that therefore the client does not benefit from the corresponding protection of the relevant conduct of business rules; and

d. the investment firm complies with its obligations under Article 18 of MiFID (conflicts of interest).

14. Recital 30 of MiFID states that a service should be considered to be provided at the initiative of a client unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients.

15. Communications that are 'by their very nature general' will lead to services that are 'at the initiative of the client'. If the other conditions for providing 'execution only' business described above are met, those services will not trigger an appropriateness test. General communications could include, for example, material in newspapers and magazines or on TV, radio or billboards. Other communication methods (such as websites and internet search results) might also fall into this category, but only if they are 'by their very nature general', which may depend on the individual circumstances.

16. Therefore, firms are likely to need processes (i) to distinguish between 'complex' and 'non-complex' products (which may already have been done at the product design stage); (ii) to identify whether contact with the client is at the initiative of the firm; and (iii) to ensure that necessary warnings have been provided.

Questions on general implementation

- What process has the firm established for assessing appropriateness?
- How have staff been trained in the process?
- How has the firm ensured that it is clear about the services it is offering and whether these are advised or not?
  - How does it communicate this clearly to its staff and other representatives?
  - How does it ensure that clients understand whether services being offered are advised or not?
  - What measures and controls has it adopted to decide whether the services offered by its employees are advised or not?
- If a firm chooses not to test appropriateness for all non-advised transactions and to use the exemption available in Article 19(6):
  - What policies and processes has the firm set up to identify which of its products may be regarded as 'non-complex' and which are therefore 'complex' for the purposes of the appropriateness requirements? Do these appear satisfactory?

- How has the firm satisfied itself about whether its business model involves 'personalised communications' that may trigger the appropriateness test? How has the firm satisfied itself that the service is being provided at the initiative of the client?

- What controls has the firm set up to ensure that it complies with the MiFID appropriateness and/or execution-only requirements?

- How has the firm implemented acceptable record keeping procedures in relation to the appropriateness test to ensure that it can demonstrate that, in respect of each client, information has been obtained and acted on in accordance with the requirements?

IV.III. Information about knowledge and experience

17. Under Article 37 of the MiFID Implementing Directive, where the appropriateness test applies (i.e. other than for execution-only transactions), a firm will need to ask for the following information from a client:

- the types of services and products with which the client is familiar;

- the nature, volume and frequency of the client's previous transactions;

- the client's level of education; and

- the client's profession or former profession.

18. However, this is not an exhaustive or definitive list of information gathering requirements. MiFID provides that the precise components and rigour of information gathering and assessment will vary according to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved. A firm may also use existing information it has (unless it is aware that the information is manifestly out of date, inaccurate or incomplete) without requesting more from the client, if it is satisfied it has the necessary information to satisfy the appropriateness test.

<u>Questions on the appropriateness test</u>

- What policies and guidance has the firm formulated for its employees and representatives about the level of information that it regards as acceptable in determining appropriateness?

- Where required, what questions does the firm ask its clients?

  - Do these questions allow the firm to determine a client's knowledge and experience to understand the risks involved in relation to the product or service offered or demanded?

  - Do the questions cover the factors indicated by the requirements of the MiFID Implementing Directive, as relevant?

  - How do these questions properly reflect the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved?

- How has the firm tried to establish whether the client has the necessary knowledge/information about the risks involved in relation to the product or service in question?
    - Does the firm encourage its clients to access information made available elsewhere?
    - Are these arrangements acceptable?
- How has the firm implemented an acceptable mechanism to keep the information on which assessments are made regularly updated? Does it have an acceptable mechanism in place for reviewing appropriateness in the event of a material change in the relevant information?
- How has the firm implemented acceptable policies and procedures when assessing appropriateness for professional clients to ensure that the relevant transaction falls within the categories for which they have been classified as 'professional' (as set out in Annex II of MiFID)?
- How does the firm analyse and assess client information to determine the appropriateness of each relevant transaction? Does it have acceptable policies and procedures in place to achieve this?

IV.IV. Format of the appropriateness test

19. How the appropriateness obligations are best integrated into a firm's particular business model and processes will be for each firm to determine. Assessing appropriateness could be done online, face-to-face, over the telephone or in hard copy documentation.

IV.V. Timing of the appropriateness test

20. MIFID is not prescriptive on when the appropriateness test is done, so firms may decide at what stage in the sales process to assess appropriateness - as long as the test is satisfied before the transaction is executed.

IV.VI. Warning the client

21. Under MiFID, if a firm considers, on the basis of the information received from its client, that the product or service is not appropriate for that client, the firm must warn the client. This warning may be provided in a standardised format.

22. If the client elects not to provide the information to enable the firm to assess appropriateness, or if he provides insufficient information regarding his knowledge and experience, the firm must warn the client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for the client. This warning may also be provided in a standardised format.

23. If a client asks a firm to proceed with a transaction, in spite of being given a warning by the firm, it is for the firm to consider whether to do so in the circumstances, taking into account the client, the nature of the service, the type of product or transaction envisaged, the particular risks for the client etc.

Questions

- What systems are in place to ensure that warnings are given where required and necessary? Are these acceptable?

- What warnings does the firm have in place:

    - to warn the client that insufficient information has been provided so the firm is unable to judge appropriateness;

    - to warn the client that the product/service is inappropriate;

    - to warn the client that in the provision of the execution-only service the firm is not required to assess the suitability of the instrument or service provided or offered and that therefore the client does not benefit from the corresponding protection of the relevant conduct of business rules.

- Are these warnings clear and acceptable?

- What policies does the firm have in place to decide whether:

    - to deal with a client if the client provides insufficient information to allow the firm to assess appropriateness;

    - to deal with a client if the client demands a service/product that the firm believes to be inappropriate?

- Are these policies acceptable?