# Guidelines on certain aspects of the Mi-FID II appropriateness and execution-only requirements

FINANCE DENMARK

**Memo**

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Finance Denmark welcomes the opportunity to respond to ESMAs consultation on appropriateness and execution-only requirements under MiFID II. We support the initiative from ESMA and the use of guidelines as they enhance clarity and foster convergence in the application of rules. In principle we agree with many of ESMA's suggested approaches. However, certain, essential elements still require further considerations before finalizing the guidelines.

Generally, we believe it is important to strongly underline the need to take a proportionate approach to the requirements based on the complexity of the intended investments and type of investor.

In the description of the purpose, it could be beneficial to outline the link to the suitability test, as parts of the requirements to the suitability test is aligned with the appropriateness test. However, an appropriateness test og and a suitability test is not the same and it is unfortunate that the draft guidelines seem to largely be based on the existing guidelines for suitability tests.

## Guideline 1 – information to clients about the purpose of the appropriateness assessment

**Q1: Do you agree with the suggested approach on providing information about the purpose of the appropriateness assessment? Please also state the reasons for your answer.**

The guideline should clearly state that the information can be provided as standardized information, e.g., through a firm's terms and conditions.

For firms providing online services pop-up boxes and interactive text are mentioned as effective ways of providing the information. However, this does not comply with the requirement that "the format used to inform clients should however enable firms to keep records of information provided". It is not possible to document and keep track of that clients have seen the information about the appropriateness testing.

In trading situations there need to be flexibility as to the requirement about "in good time".

Paragraph 14 first bullet states, that "[…] and the importance of providing information that is up to date." This only seems to be relevant in the case of a suitability test.

## Guideline 2 – Arrangements necessary to understand or warn clients

**Q2: Do you agree with the suggested approach on the arrangements necessary to understand or warn clients? Please also state the reasons for your answer.**

Generally, there is a tendency that some clients may experience the described approach as an exam, which could discourage them from investing.

The guideline is putting restrictions on the possibility for clients to trade financial instruments. We have some doubts whether the proposed cooling-off period and the limiting the number of attempts to respond to a questionnaire, as currently written, comply with Article 25(3) of MiFID and Article 56(2) of the MiFID II Delegated Regulation. Those allow clients to proceed with transactions after failing an appropriateness test, provided that they have received a warning.

In a situation where a firm has implemented a process where a client is blocked from trading until an appropriateness test has been passed, a cooling off period or limiting the number of attempts would only create an illusion that the client would have a greater knowledge later. The guideline is ambiguous as it opens for implementation of a very wide range of different approaches and generating arbitrary situations between firms leaving up to the firm to decide on the number of allowed and the length of the cooling off period.

The last bullet in subparagraph 26 is inconsistent with the other comments made by ESMA regarding cooling off periods and that clients should not be able to repeat assessments/tests.

The last sentence of paragraph 27 seems unnecessarily overprotective. It should suffice to clearly state the purpose of collecting the information, outlining on a high level the type of information intended to collect and encouraging the client to provide the information. Based on this information the client should be allowed to decide not to provide the information.

Furthermore, it should be outlined in the guidelines that there are not any legal requirements in regard to the method of collecting the information as long as it is relatively easy for the client to provide the information (e.g., in an online service it should be possible to direct a client to personal interaction with an advisor in regard to collecting the information).

## Guideline 3: Extent of information to be collected from clients (proportionality)

**Q3: Do you agree with the suggested approach on the extent of information to be collected from clients? Please also state the reasons for your answer.**

In regard to paragraph 33, it should be emphasized that even though a sufficient granularity in categorizing the types of financial instruments is needed in connection with assessing experience and knowledge the level of granularity should not be at a level where it borderlines becoming a suitability test.

**Q4: Do you agree with the suggested approach regarding the appropriateness assessment relating to a service with specific features (paragraph 34 of the Guidelines)? In particular, do you agree with the examples provided (bundled services and short selling), or would you suggest including other examples? Please also state the reasons for your answer.**

Yes, as long as there is proportionality in the requirements, including the documentation. However, both investment credits (i.e., leveraging) and short selling are good examples of services where it should be ensured that the clients have the necessary experience and knowledge with the service.

For simple and "standardised" services such as pure execution services the requirements including the documentation should be limited.

Though the guideline does not intend to provide guidance on investment advice and portfolio management, it should perhaps be considered what the spill over effects are on these services.

## Guideline 4: Reliability of client information

**Q5: Do you agree with the suggested approach on the reliability of client information? Please also state the reasons for your answer.**

Paragraph 38 states that Firms should have consistency control on replies in place in order to highlight contradictions in information collected. Does this mean that if questionnaires are used, they should all be designed to cross-examine answers from the client? This would be very burdensome and result in "double-up" in questions.

## Guideline 5: Relying on up-to-date client information

**Q6: Do you agree with the suggested approach on relying on up-to-date client information? Please also state the reasons for your answer.**

The guideline seems to take its starting point in how a suitability assessment works. It therefore seems somewhat disproportionate. If an investment firm has concluded based on a sufficient appropriateness test that a client has the necessary experience and knowledge for simple financial instruments or one or more less complex instruments to be appropriate, it should not be necessary to update the information regularly as it seems disproportionate to assume the customer lose

the understanding of the financial instrument to make it appropriate to trade. There should not be put proactive requirements on firms in non-advisory services to periodically reach out to clients to update information or request confirmation of previously delivered information. For simple and less complex instruments as defined in article 25 (4) (a) in MiFID II, it should be sufficient to update the information, if the client has refrained from trading for several years.

For more complex instruments it seems relevant to have procedures for updating and ensuring the client still has the necessary understanding of the different types of financial instruments to be appropriate, especially if the client has not been active for a longer period of time.



Paragraphs 42 to 45 seem to point to an advisory service or at least an ongoing service and/or ongoing interaction of some sort. However, this is not the case for execution services which are dependent on the client engaging the firm and initiating trading services. A firm assesses appropriateness in the trade situation and not on a periodic basis, unless of course a client engages the firm on multiple occasions throughout a year for example and then trades different types of financial instruments. A firm cannot in general know when to contact a client because of potential changes regarding knowledge and experience. The relevant thing should be that the firm, in the situation when the client engages the firm, include in its process that the client should have the ability to update information and/or that the firm should be able to update a previously made assessment.

Paragraph 44 states that a firm need to have arrangements in place to ensure an update of a client's information on his knowledge and/or experience in a case where "unusual transactions are registered on the client's account". This would mean that firms have to monitor client's account on an ongoing basis in order to evaluate whether a client's transactions are appropriate. This would be very burdensome, costly and also unnecessary due to the warning the client has received when entering into these transactions.

We do not at all understand ESMA's reasoning regarding the risk of clients updating their knowledge and experience "too frequently". It must be kept in mind that firms do not dictate how often a client wants to trade different types of instruments and the firm's responsibility is to assess the client's knowledge and experience in relation to the instrument type which is relevant for the trade at hand. If a client has gained knowledge of certain instruments at different times during a three-month period and therefore engages the bank 10 times to per-

form transactions, it would be necessary to "update" the knowledge and experience assessment whenever the client would engage with an instrument type for which the client has not yet passed an appropriateness assessment.

To require that two staff members should be involved in making the assessment or controlling the assessment seems unnecessarily burdensome. Firstly, every single staff member involved in a knowledge and experience assessment should have the sufficient knowledge and competence to make the call himself/herself. Secondly, having two staff members involved would put an unproportionate burden on the client who very well may want to execute a transaction which is time sensitive.



## Guideline 6: Client information for legal entities or groups

**Q7: Do you agree with the suggested approach on client information for legal entities or groups? Please also state the reasons for your answer.**

The section seems to be copied from the suitability guidelines and not at all adjusted to the appropriateness test. The guideline is a bad fit for a guideline dealing with execution services. In an online trading tool, company representatives have to be coded into the client's profile so that the system/platform recognizes pre-defined representatives. When dealing with a company client the starting point is then that the designated company representative is set either through a PoA or based on the company's articles of association. This is done when setting the client up to start using online trading services.

For front line staff dealing with clients over the phone the question about the handling of representatives should be covered by an internal conduct of business instruction, but it does not make sense to require a dedicated policy for how to conduct an appropriateness assessment for representatives.

Paragraph 50 may cause some confusion. It would be beneficial for the reader to emphasise that for a group of legal entities within a company group. The starting point is that each entity should be assessed separately similarly to each entity within a group being client categorised separately.

## Guideline 7: Arrangements necessary to understand investment products

**Q8: Do you agree with the suggested approach on the arrangements necessary to understand investment products? Please also state the reasons for your answer.**

We suggest that EFAMA reconsider this guideline as it is unnecessary complex and overlaps MiFID II rules on product governance.

Regarding paragraph 54, it seems unnecessarily burdensome to require investment firms to obtain data from more than one source if the data source has been assessed as reliable.

## Guideline 8: Arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning

**Q9: Do you agree with the suggested approach on the arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning? Please also state the reasons for your answer.**

In order to keep the warning simple, precise and easily understandable and at the same time ensure that clients are encouraged to provide the necessary information and discouraged from proceeding without the investment being assessed appropriate, it does not seem to provide value to outline whether the issue is a lack of providing information or because it has been assessed inappropriate due to the information provided. Rather, it will extend the warning provided.



## Guideline 9: Effectiveness of warnings

**Q10: Do you agree with the suggested approach on the effectiveness of warnings? Please also state the reasons for your answer.**

We refer to our comments to question 9.

## Guideline 10: Qualifications of firm staff

**Q11: Do you agree with the suggested approach on the qualifications of firm staff? Please also state the reasons for your answer.**

No comments.

## Guideline 11: Record-keeping

**Q12: Do you agree with the suggested approach on record-keeping? Please also state the reasons for your answer.**

No comments.

**Q13: Do you see any specific difficulties attached to the requirement to keep records of any warnings issued and any corresponding transactions made by clients?**

No comments.

## Guideline 12: Determining situations where the appropriateness assessment is required

**Q14: Do you agree with the suggested approach on determining situations where the appropriateness assessment is needed? Please also state the reasons for your answer.**

Paragraph 82 needs further clarification as to what types of interaction that needs recordkeeping besides the performing of an appropriateness test and the information obtained from the client.

Regarding paragraphs 82, 83 and 86 in situations where a non-advised transaction is made through a direct personalized communication with an employee of the firm (so called hand-held situations) firms should have internal instructions for employees to be able to distinguish between transactions falling within the execution-only exemption and other non-advised transactions. However, it is a completely different case for self-service tools and platforms where clients log on themselves to initiate orders and execute transactions. A client, who logs on to a self-service channel to execute a transaction, would be based on either one of the three situations happening prior to that the client initiates the order:



1. The client has made its own assessment of equity A and logs on to the firm's self-service channel and initiates a trade.
2. The client has had a chat with an equity broker at the firm where they talked about the equity market in general and equities A, B and C specifically. The client some time thereafter logs on to the firm's self-service channel to initiate a trade in equity A.
3. The client has received a personalized communication through an e-mail subscription whereby the firm communicates its house views on a certain equity model portfolio. The client some time thereafter logs on to the firm's self-service channel and initiates a trade in equity A which is covered by the communication.

The examples could be further complicated by adding a scenario where the client logs on to the firm's self-service channel and initiates a trade in equity A as well as a trade in equity D, which is not covered by the communication in points 2 or 3 above. There are no possible connections between the type of communication in points 2 and 3 on one hand and a firm's self-service channel on the other hand. How should the underlying logic of a self-service channel know whether a client that logs on to it has been in contact with e.g., a broker and/or has received a communication in written form via e-mail?

The wording in paragraph 86 is very broad. In situations where a client has received personalised communication or even has been advised and refrains from trading in the specific situation, but then decides to trade afterwards in a self-service channel, it should be made clear that the investment firm is not obliged to link the personalised communication to a trade. If paragraph 86 were to become the norm, it would in practice mean that firms can no longer make use of the execution-only regime in pure self-service channels. It would create a situation where firms would need to design and apply a general appropriateness test for all non-professional clients just in order for them to get access to and use a

pure self-service channel. Given that the instruments in scope here are non-complex, this type of result of the proposed Guidelines would go against the intention of the execution-only regime as stated in the MiFID II Directive. Furthermore, it would act contrary to providing clients with efficient access to financial instruments which have been deemed to not pose material risks from a client protection perspective.

As for hand-held situations the firm's internal instructions should define the boundaries of what is to be considered as execution-only and what is not. The employee having the conversation with the client will in most cases be completely unaware of whether a client has received previous communication. Therefore, the employee should be able to assume that the order is made on the client's initiative, unless the client informs the employee of the previous communication or the employee has knowledge about the previous communication.



A question that would also need to be addressed is for how long the firm should consider that previous communication would prevent the use of the execution-only regime and the impact it would have on the need for traceability. At what point in time can firms consider that the communication is no longer valid from the perspective of defining a transaction as in scope or out of scope from the execution-only regime?

Considering all these aspects, requiring firms to trace whether the order is made in response to a personalized communication would be unproportionate. It should be sufficient that quality assurance testing is made based on for example a review of how well employees adhere to the firm's internal instructions (with components like documentation of appropriateness assessments and taped calls). Furthermore, we would advocate for the following:

a) transactions initiated by clients through the use of pure self-service channels should always be seen to be made on the initiative of the clients.
b) for client transactions that are made in hand-held situations firms should have internal instructions to define the boundaries between situations that fall within the execution-only regime and situations that cannot be handled within the execution-only regime; and
c) that the proposed paragraph 86 under Guideline 12 is deleted

## Guideline 13: Controls

**Q15: Do you agree with the suggested approach on controls? Please also state the reasons for your answer.**

No comments.

## Sustainable finance

**Q16: When providing non-advised services, should a firm also assess the client's knowledge and experience with respect to the envisaged investment product's sustainability factors and risks? If so, how should such sustainability factors and risks be taken into account in the appropriateness assessment? Please also state the reasons for your answer.**

Knowledge and experience regarding sustainability factors and risks should not be a separate element or requirement for firms to assess. It seems methodically incorrect to consider experience and knowledge of sustainability factors as it is rather a matter of attitude/preferences and therefore a disclosure matter and not an appropriateness.