European Securities and Markets Authority

MiFID Supervisory Briefing

Suitability

19 December 2012 | ESMA/2012/850

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] suitability 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 provides some further detail on the function of the MiFID suitability requirements 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 applies in relation to the application of the following MiFID provisions:

   - Article 19(4) of MiFID (2004/39/EC).

   - Articles 35 and 37 the MiFID Implementing Directive (2006/73/EC).[2]

III. Status of this document

6. This document is issued in terms of Article 29 of the ESMA Regulation.[3]

IV. Purpose

7. MiFID and the MiFID Implementing Directive place various requirements on firms when they provide investment advice or discretionary portfolio management services that do not apply when

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[1] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004.
[2] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council.
[3] 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.

providing other investment services. Notably, these include requirements to ensure that (when providing advice) any personal recommendations made or (when providing discretionary portfolio management services) any discretionary investment decisions taken on behalf of clients are suitable for each client.

8. The MiFID suitability rules give firms a certain degree of flexibility in complying with the duty to obtain the necessary information about the client's circumstances on the one hand, and using this information in making recommendations or taking investment decisions on the other hand. In most circumstances, supervisors will have to assess the adequacy of a firm's arrangements on a case-by-case basis, having regard to the proportionality principle and a firm's operational framework.

9. This supervisory briefing is designed to help supervisors make these judgements, and is structured around the following elements:

   - determining situations where the suitability assessment is required;
   - obtaining information from clients; and
   - the duty to ensure suitability when providing investment advice or discretionary portfolio management services.

10. Each element includes an overview of the outcomes that the rules promote, illustrates the potential risks, and provides examples of the sort of questions that supervisors could ask to test whether the outcomes are being met by firms.

V. Briefing

V.I. Determining situations where the suitability assessment is required

11. According to Article 19(4) of MiFID, when providing investment advice or discretionary portfolio management services, firms must ensure that the specific transaction to be recommended, or entered into in the course of providing a discretionary portfolio management services service, is suitable for the client in question.

12. On the one hand, it is crucial for the firm to put in place arrangements and procedures to detect any situation where the interaction between itself and the client or potential client will require an assessment of suitability. In this context, since the suitability requirement can affect the firm's ability to sell certain types of (complex and/or risky) financial instruments to most retail clients, it is important to bear in mind the risk of improper classification of the service as 'non-advised' although a personal recommendation is given.

13. On the other hand, given the wide scope of the definition of 'investment advice', firms that do not intend to give advice should put in place either specific and sound internal systems and controls or focused staff training in order to appropriately and consistently reflect the nature of the 'non-advised' service they are providing.

14. Firms that provide both investment advice and non-advised services must take care to avoid situations where it is not clear on which basis the transaction has been performed.[4] For example, if the firm advises the client that a transaction is unsuitable, it should consider carefully if it is in the best interests of the client to allow the transaction to proceed on an execution-only basis. Firms should also consider what procedures they should have in place to demonstrate that this is the case.

15. 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.

<u>Questions on general implementation</u>

- How do the firm's arrangements and procedures guide the interaction between staff and clients, having regard to the distinction between 'advised' and 'non-advised' services?
    - What kind of safeguards are in place in order to avoid any personal recommendation being made in situations where a suitability assessment is not envisaged?
    - What happens if a transaction to be recommended on a product distributed by the firm is deemed unsuitable for the client?
    - How do the firm's procedures track and record the interaction between staff and clients, having regard to the distinction between 'advised' and 'non-advised' services?
- How are relevant staff trained on the suitability assessment?
- Where a suitability assessment is not envisaged, what kind of internal systems and controls are in place in order to ensure that the services given do not amount to advice?
    - In the case of customer-facing staff providing 'non-advised' services, how are they trained on the risk of inadvertently giving a personal recommendation on a given financial instrument?
- Does the information on investment advice and portfolio management services, given to clients, include information about the suitability assessment?

V.II. Obtaining information from clients

16. According to Article 35 of the MiFID Implementing Directive – which stems from Article 19(4) of MiFID – when providing investment advice or discretionary portfolio management services, firms must obtain the necessary information in order to understand the essential facts about the client so that they can assess whether the specific transaction to be recommended, or entered into during the course of providing a discretionary portfolio management service, is suitable for the client in question.

[4] See "Question and Answers - Understanding the definition of advice under MFID" (Ref: 10/293, published 19/4/2010) http://www.esma.europa.eu/system/files/10_293.pdf.

17. Therefore, a firm should obtain all relevant information about the following aspects of a client's circumstances, as further detailed by Articles 35 and 37 of the MiFID Implementing Directive:

- investment objectives (including, as relevant, holding period, risk taking preferences, risk profile and purposes of the investment); and

- financial situation (including, as relevant, source and extent of regular income, assets and financial commitments, and the client's ability to financially bear any related investment risks); and

- experience and knowledge (including information to enable the firm to assess the client's ability to understand the risks involved in any transaction or in the management of his portfolio).

18. The firm should obtain the information which is necessary and relevant for the prospective investment activity of the client, giving due consideration to the nature and extent of the service and the specific transaction in question.

19. Moreover, a client's categorisation is also relevant in this context since, where an investment firm provides the service to a professional client, it is entitled to assume that the client has the necessary level of experience and knowledge. Similarly, where that investment service consists of the provision of investment advice to a professional client who is covered by Section 1 of Annex II of MiFID, the investment firm is entitled to assume that the client is able financially to bear any related investment risks consistent with the investment objectives of that client.

20. 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.

21. The firm should adopt arrangements and procedures which enable it to meet the requirements of Article 35 of the MiFID Implementing Directive on an ongoing and consistent basis for any client and irrespective of the channel of interaction used. In this context, it is particularly important that clients are classified in a manner consistent with their personal circumstances and that safeguards are in place in order to avoid the outcome that client profiling is driven by the need to promote a given financial instrument.

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

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

- 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

- take steps to ensure the consistency of client information.

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

24. Investment firms should at least:

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

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

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

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

<u>Questions</u>

- What arrangements and procedures has the firm set up to ensure that relevant and necessary information about essential client facts is obtained?

- What mechanism is used to obtain information that gives due consideration to all relevant and necessary facts about the client? In particular, how are relevant facts regarding investment objectives (holding period, risk taking preferences, risk profile and purposes of the investment), financial situation (source and extent of regular income, assets and financial commitments) and knowledge and experience (ability to understand the relevant financial instrument and in particular the risk to be taken) assessed and used to determine suitability?

- Has the firm established some general client profiles with reference to the three relevant dimensions (i.e. investment objectives, financial situation, experience and knowledge)? If so, how do the arrangements and procedures of the firm lead to the assessment of each client within the various profiles established? How do these general categories continue to satisfy the need to take into account a client's particular circumstances?

- Is the information about clients also matched consistently with the features of the services and financial instruments distributed by the firm?

    - How is the intended holding period of the client considered where the service provided involves illiquid financial instruments, to ensure that the instrument is suitable?

- Are clients asked to make any degree of 'self-assessment' (e.g. in respect of their attitude to risk/knowledge and experience)? If so, does it seem reasonable for the client to make such a self-assessment?

    - Is the self-assessment counterbalanced by objective criteria?

- How are relevant staff trained on the way to obtain relevant information from the client?

    - Do relevant staff understand the role they play in the suitability assessment process and do they possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulatory requirements and procedures, to discharge their responsibilities?

  - Do relevant staff have the skills necessary to be able to assess the needs and circumstances of the client?

- What are the arrangements used to keep the client profile updated? Do these appear reasonable?

- Under what circumstances might the firm amend the client profile? Does this involve the agreement of the client? Has the risk of unjustified client profile changes been considered (for example, to avoid the situation where the sales force may have an interest in recommending some products which do not match the client's profile); and how is it managed?

- What kind of internal systems and controls are in place in order to ensure that the client profile reflects all relevant facts about the client? Do these appear reasonable?

- Has the firm established adequate record keeping arrangements?

  - Are record-keeping arrangements adopted by investment firms designed to enable firms to track ex-post why an investment was made?

  - Does the firm 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?

V.III. Duty to ensure suitability when providing investment advice or portfolio management

25. MiFID requires firms to assess that the specific transaction to be recommended or entered into in the course of providing discretionary portfolio management services is suitable.

26. Therefore, a firm must assess if the specific investment decision involved meets the investment objectives, financial situation and knowledge and experience of the client in question.

27. To this end (as noted above), the firm should implement arrangements and procedures which enable it to meet the requirements of Article 19(4) of MiFID and Articles 35 and 37 of the MiFID Implementing Directive on an ongoing and consistent basis for any client - irrespective of the channel of interaction used. In this context, it is particularly important that the features of the financial instrument involved are assessed against the client's personal circumstances, and that safeguards are in place in order to avoid an outcome where the suitability assessment is undermined by the need to promote a given financial instrument.

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

- 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)

- all material characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.

Questions - Understanding products before the recommendation/transaction

- What approach does a firm adopt in assessing the features of each transaction or portfolio in order to ensure its suitability for the client in question? Does this seem reasonable?
- How does the firm select suitable investments when providing advice or portfolio management services?
- Are the procedures used capable of assessing all relevant facts about the financial instrument?
    - In particular, are features regarding complexity, possible returns, risk, prospective financial commitment for the client and liquidity of the financial instrument considered, where relevant?
- Has the firm established some general categories within different kinds of financial instruments?
    - If this is the case, how do the arrangements and procedures of the firm lead to the classification of each financial instrument within the various established categories?
    - How do the categories assigned track relevant features of the financial instrument?
- What degree of discretion is left to relevant staff when assessing financial instruments?
    - Is this degree of discretion reasonable? Has the risk of an unjustified assessment been considered (for example, where there is an interest to consider a given financial instrument as suitable for as many clients as possible in order to favour its marketing)?
- What arrangements are used to keep the evaluation of financial instruments updated?
- What kind of internal systems and controls are in place in order to ensure the understanding of all relevant financial instruments is considered? Do these appear reasonable?

Questions - Ensuring a recommendation/transaction is suitable for the client

- How do arrangements and procedures ensure that relevant information about financial instruments is matched with the client's circumstances?
    - Is the mechanism used capable of covering all relevant financial instruments and transactions possibly considered by the firm when providing advice or portfolio management services to any client?
    - How are the risks of financial instruments assessed against the client profile?

- How is the liquidity of financial instruments considered in relation to client's holding period?

- Does the firm employ appropriate record keeping processes to be able to demonstrate the suitability of its investment advice and decisions to trade (portfolio management services)?

- What arrangements and procedures has the firm set up in order to ensure that its employees or representatives do not propose unsuitable transactions or strategies to clients?

- What happens if a transaction that is proposed by a client is deemed unsuitable by the firm, but the client wishes to proceed on a non-advised basis (under MiFID's appropriateness or execution-only regimes)? How does the firm determine if allowing this is in the best interests of the client?

- What degree of discretion is given to relevant staff when assessing suitability? Is this degree of discretion reasonable?

- What kind of internal systems and controls are in place in order to ensure that only suitable products are recommended to a client or are considered within the portfolio management service? Do these appear reasonable?