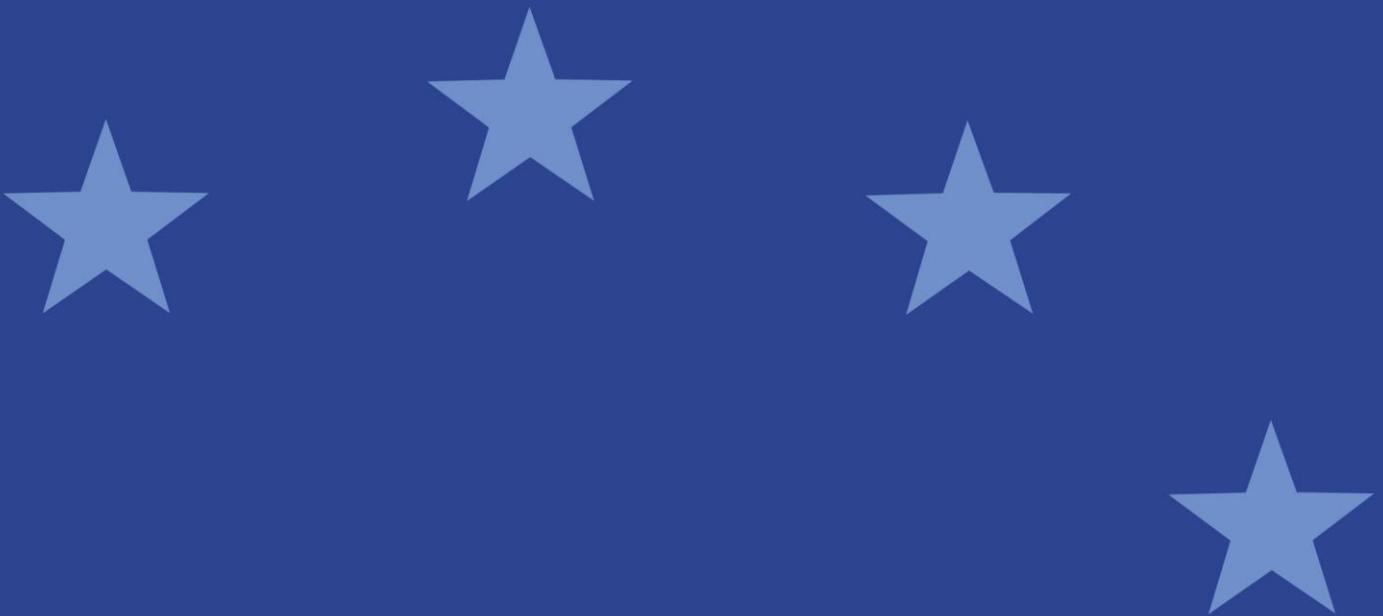




European Securities and  
Markets Authority

## Consultation paper

Guidelines on certain aspects of the MiFID suitability requirements



## **Responding to this consultation paper**

ESMA invites comments on all matters set out in this consultation paper and, in particular, on the specific questions listed in Annex 1. Comments are most helpful if they:

- indicate the number of the question to which the comment relates;
- respond to the question stated;
- contain a clear rationale, also clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by **24 February 2012**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Consultations'.

### **Publication of responses**

All contributions received will be published following the end of the consultation period, unless otherwise requested. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

### **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Disclaimer'.

### **Who should read this paper?**

This paper is primarily of interest to competent authorities and firms that are subject to MiFID – in particular, investment firms and credit institutions providing investment advice or discretionary portfolio management services. This paper is also important for trade associations, investors and consumer groups because MiFID's suitability rules are intended to ensure that firms obtain the necessary information about the client's circumstances, and use that information in making recommendations or taking investment decisions that are suitable for their clients.

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## **Acronyms**

ESMA            European Securities and Markets Authority

MiFID           Markets in Financial Instruments Directive

## **I. Executive summary**

### **Reasons for publication**

1. In accordance with Article 16(2) of the ESMA Regulation<sup>1</sup>, this paper sets out for consultation draft ESMA guidelines on certain aspects of the Markets in Financial Instruments Directive (MiFID)<sup>2</sup> suitability requirements.
2. The purpose of these draft guidelines is to enhance clarity and foster convergence in the implementation of certain aspects of the MiFID suitability requirements. They focus mainly on the need for firms to have in place appropriate policies and procedures in order to know their clients when recommending suitable investment choices. This should help investment firms improve their implementation of the requirements and strengthen investor protection.
3. The guidelines do not address all issues relating to the suitability requirements or to the related obligations of investment firms. For example, they do not address client information requirements generally, internal controls, or organisational requirements regarding the launch of products that firms should comply with to ensure that the client base of the firm includes clients for whom any newly approved products would be suitable.

### **Contents**

4. Section II explains the background to the proposals, Section III sets out the draft guidelines on certain aspects of MiFID suitability requirements.
5. Annex I lists all the questions set out in the consultation paper; Annex II contains the high-level cost-benefit analysis; and Annex III contains the full text of the draft guidelines.

### **Next steps**

6. ESMA will consider the responses it receives to this consultation paper in Q1 2012 and expects to publish a final report, and final guidelines, in Q2 2012.
  7. ESMA has considered the contents of this consultation paper in light of the MiFID review proposals, and confirms that these proposals for guidelines, which are based on the current MiFID requirements, are not affected by those proposals.
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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.

<sup>2</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments.

## II. Background

8. Article 19(4) of MiFID states that when providing investment advice<sup>3</sup> or portfolio management services, investment firms<sup>4</sup> must ensure that the specific transaction to be recommended, or entered into in the course of providing a portfolio management service, is suitable for the client<sup>5</sup> in question.
9. Accordingly, before providing investment advice or portfolio management services, investment firms must obtain the necessary information to be able to understand the essential facts about the client in order to assess the suitability of any investment<sup>6</sup> for that client. This necessarily encompasses information about the client's:
  - (a) investment objectives (including, where relevant, holding period, risk-taking preferences, risk profile and the purpose for which the investment is sought);
  - (b) financial situation (including, where relevant, source and extent of regular income, investments, other assets and financial commitments); and
  - (c) knowledge and experience (including information to enable the firm to assess the client's ability to understand the risk involved in any transaction recommended or undertaken in the management of his portfolio).
10. Based on the information collected, an investment firm is required to assess that the specific transaction to be recommended or entered into in the course of providing portfolio management service is suitable. Therefore, a firm must assess whether the specific investment decision involved meets the investment objectives, financial situation and knowledge and experience of the client in question. Given the differences between firms in size, structure and business, the measures put in place to collect and assess client information as part of the suitability process should be best suited to the nature and circumstances of each firm.
11. To this end, an investment firm should adopt arrangements which enable it to meet the requirements of Article 19(4) of MiFID and Articles 35 and 37 of the MiFID Implementing Directive<sup>7</sup> on an ongoing and consistent basis for any client, and irrespective of the distribution channel used (for example, through direct face-to-face contact with their clients, or through the internet). A firm should also keep records enabling it to demonstrate compliance with the suitability requirements.
12. Assessing suitability is an important MiFID investor protection requirement. Recent evidence<sup>8</sup> and supervisory experience indicates that full and effective compliance with the MiFID suitability require-

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<sup>3</sup> Note that it is important for investment firms to have arrangements in place to detect any situation where interaction with the client requires an assessment of suitability. In April 2010, subsequent to consultation, CESR published Q&A entitled 'Understanding the definition of advice under MiFID' (Ref. CESR/10-293) to help firms to understand whether the services they provide amount to investment advice. Investment advice is an investment service under MiFID and is subject to the suitability requirements.

<sup>4</sup> 'Investment firm' means an investment firm, a credit institution or a UCITS management company when providing investment services. Only UCITS management companies providing individual portfolio management are covered by these guidelines.

<sup>5</sup> 'Client' means the client or potential client of the investment firm.

<sup>6</sup> 'Investment' means a transaction recommended to the client or entered into in the course of providing a portfolio management service. Where appropriate, this should be understood as including an investment strategy.

<sup>7</sup> Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC.

<sup>8</sup> See for example: European Commission, Consumer Market Study on Advice within the Area of Retail Investment Services - Final Report, 2011; AMF, Evaluation des questionnaires MIF en France, February 2011; UK-FSA, Assessing suitability, March 2011.

ments is not as consistent or as wide-spread across EEA member states as it could or should be. This necessarily compromises both MiFID's and ESMA's investor protection aims.

13. Generally, the main issues observed regarding compliance with the MiFID suitability requirements include:
  - (a) failure to ask clients the right questions;
  - (b) failure to collect the necessary and relevant information;
  - (c) failure to interpret correctly the information provided by the client; and
  - (d) even where the right information is collected, failure to recommend, or enter into in the course of providing a portfolio management service, a suitable investment.
14. More specific problems include the following:
  - (a) lack of efforts by firms to gather sufficient information about the client, especially his investment objectives and financial situation;
  - (b) tendency of firms to overlook the client's education level and profession;
  - (c) tendency of firms to rely excessively on assessments by the clients themselves of their level of knowledge and experience and financial situation;
  - (d) over-reliance by firms on poorly designed risk-profiling and asset-allocation tools;
  - (e) poor understanding by firms' employees of products as well as inadequate classification of products (risk/return estimates);
  - (f) failure by firms to select suitable investments (for example, selecting excessively risky, complex or expensive investments; selecting the most profitable investments for the firm); or to select suitable investments strategies (for example, recommending trades with a frequency that is not in the best interest of the client);
  - (g) firms attempting to evade their responsibility to give suitable advice by giving the impression that it is the client who decides on the suitability of an investment;
  - (h) poor recording by firms of the suitability process (for example, client profiling, product classification, advice provided or portfolio management decisions taken).
15. Therefore, in order to address the observed problems, ESMA proposes issuing guidelines on certain aspects of the MiFID suitability requirements to enhance clarity and to foster convergence in their implementation.
16. The guidelines do not address all issues arising in connection with the suitability requirements or relating to the obligations of investment firms in this regard. For example, they do not address the

general requirements for client information, managing conflicts of interests, internal controls, or those regarding organisational requirements that firms should comply with for the launch of products.<sup>9</sup>

### III. Guidelines on certain aspects of the MiFID suitability requirements

#### III.I. Information to clients about the suitability assessment

**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 during the suitability assessment process, or when informing clients, should investment firms create any ambiguity or confusion about their own responsibilities in the process.**

17. Article 19(3) of MiFID requires investment firms to provide appropriate information to their clients about the services they provide. Information on investment advice and portfolio management services should therefore include information about the suitability assessment.<sup>10</sup> This should help clients to understand the purpose of the requirements and 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 the most suitable product or service for the client.
18. Investment firms should take steps to ensure that the client understands the relationship between risk and return on investments, and should inform the client about how a risk profile is established.
19. The suitability assessment is the responsibility of the investment firm. In this regard, 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 his own risk profile (for example, by indicating to the client that a certain financial instrument is the one that the client chose as being suitable, or by requiring the client to confirm that an instrument or service is suitable).

**Q1: Do you agree that information provided by investment firms about the services they offer should include information about the reason for assessing suitability? Please also state the reasons for your answer.**

#### III.II. Arrangements necessary to understand clients and investments

**Investment firms should 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.**

20. Article 19(4) of MiFID and Article 35(1) of the MiFID Implementing Directive require investment firms to understand the essential facts about the client and the characteristics of any investments that may be recommended to the client or made on his behalf in providing a portfolio management service.

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<sup>9</sup> According to those requirements, firms will need to define to which clients the product will be targeted. Note that this does not replace the requirement to assess the suitability of a given product for a given client.

<sup>10</sup> In this paper, '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.

21. Investment firms should therefore establish, implement and maintain all policies and procedures (including appropriate tools) necessary to be able to understand those essential facts and characteristics.<sup>11</sup>
22. Investment firms should know their clients. This means that firms should implement policies and procedures that enable them to collect, for example through questionnaires completed by their clients, and assess all information necessary to conduct a suitability assessment for each client. For example, in many cases it is unlikely that a firm will be able to meet its obligations if it is unaware of, or fails to consider, the client's age, marital status, family situation, employment situation, or need for liquidity in certain relevant investments.
23. 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 they understand the characteristics of the product, or financial instrument, involved.

**Q2: Do you agree that investment firms should establish, implement and maintain policies and procedures necessary to be able to obtain an appropriate understanding regarding both the essential facts about their clients, and the characteristics of financial instruments available for those clients? Please also state the reasons for your answer.**

#### III.III. Qualifications of investment firm staff

**Investment firms should ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise.**

24. Staff should understand the role they play in the suitability assessment process and possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulations and procedures, to discharge their responsibilities.
25. Staff should have the skills necessary to be able to assess the needs and circumstances of the client. They should also have sufficient expertise in financial markets in order 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.

**Q3: Do you agree that investment firms should ensure that staff involved in material aspects of the suitability process have the skills and the expertise to discharge their responsibilities? Please also state the reasons for your answer.**

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

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

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<sup>11</sup> See Article 13(2) of MiFID.

26. 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.<sup>12</sup>
27. The extent of information collected may vary. This is because 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 (including the complexity and level of risk) of the financial instrument or transaction to be recommended or entered into;
  - (b) the nature and extent of the service;
  - (c) the nature, needs and circumstances of the client.
28. When providing access to complex (as defined in MiFID) or risky financial instruments, firms should bear in mind the need to collect more in-depth information about the client in order to be able to assess the client’s capacity to understand, and financially bear, the risks associated with such instruments.
29. For example, for risky or illiquid financial instruments, the ‘necessary information’ to be gathered will include information on the length of time for which the client is prepared to hold the investment and may include all of the following elements with respect to his financial situation:
  - (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 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 ascertaining what financial commitments the client has made or will be making within a timeframe that would affect any investment the client wished to make (or that the firm wished to recommend or enter into in the course of providing a portfolio management service).
30. 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 advisory 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;

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<sup>12</sup> See Articles 19(1) and (4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.

- (b) when portfolio management services are to be provided, as investment decisions are to be made by the firm on behalf of the client, it is reasonable to consider that the client's level of knowledge and experience 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 advisory service is to be provided. Nevertheless, even in such situations, the client 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.
31. Similarly, the extent of the service requested by the client may also impact the level of detail collected about the client. For example, firms would need to collect more information about clients asking for investment advice covering their entire financial portfolio than for clients asking for specific advice on how to invest a given amount of money.
  32. An investment firm should also take into account the nature of the client when determining the information to be collected. For example, where a firm provides investment advisory 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.
  33. Similarly, where the investment service consists in the provision of investment advice to a 'per se professional client'<sup>13</sup> 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 will be required, 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.
  34. Other elements regarding the nature of the client, such as age, family situation or educational level may also impact the level of information to be collected.
  35. 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.
  36. If an investment firm does not obtain sufficient information in order to be able to provide an advisory or portfolio management service that is suitable for the client, it must refrain from providing any such service to that client.<sup>14</sup>

**Q4: Do you agree that investment firms should determine the extent of information to be collected about the client taking in to account the features of the service, the financial instrument and the client in any given circumstance? Please also state the reasons for your answer.**

#### III.V. Reliability of client information

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<sup>13</sup> As set out in Section I of Annex II of MiFID ('Categories of client who are considered to be professionals').

<sup>14</sup> See Article 35(5) of the MiFID Implementing Directive.

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

- **not rely on clients' self-assessment;**
- **ensure that all tools employed in the suitability assessment process are appropriately designed; and**
- **take steps to ensure the consistency of client information.**

37. Notwithstanding a client's responsibility to provide correct, up-to-date and complete information for the suitability assessment, investment firms should take reasonable steps to ensure the reliability of information collected about clients. This implies, amongst other things, that when collecting information about a client, investment firms should take care to ensure that the questions asked are likely to be understood.
38. For the same reason, investment firms should avoid relying unduly on the client's own assessment of his knowledge, experience and financial situation. 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 a client whether he believes he has sufficient funds to invest, the firm could ask the client for factual information about his financial situation;
  - (c) instead of asking a client whether he feels comfortable with taking risk, the firm could ask the client what level of loss over a given time period he would be willing to accept, either in the individual investment or on his portfolio.
39. Where investment firms rely on tools to be used by clients (such as on-line questionnaires, or risk-profiling software) as part of the suitability process, they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. Firms should also mitigate potential risks associated with the use of the tools. Potential risks may arise, for example, 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; or where questions are drafted in a such way that they lead the client to a specific type of investment.
40. 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 contradictions between different pieces of information collected, and contact the client in order to resolve any potential inconsistencies or inaccuracies (such as little knowledge or experience and an aggressive attitude to risk, or a prudent risk profile and ambitious investment objectives).

**Q5: Do you agree that investment firms should take reasonable steps (and, in particular, those outlined above) to ensure that the information collected about clients is reliable and consistent? Please also state the reasons for your answer.**

### III.VI. Updating client information

**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.**

41. Article 37(3) of the MiFID Implementing Directive states that investment firms are entitled to rely on the information provided by their clients, unless they are aware or ought to be aware that the information is manifestly out of date.
42. Firms' procedures should therefore define the minimum level of information required for each client and the information that is subject to updating, the circumstances to be taken into account in order to request additional or updated information (which may be specific to the type of client involved and service provided, and will involve an appropriate time period for updating), and the action to be taken by the firm (such as a change in the client profile) when additional or updated information is received or when the client fails to provide the information requested.

**Q6: Do you agree that 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? Please also state the reasons for your answer.**

### III.VII. Client information for legal entities or groups

**Where a client is a legal entity or a group of two or more natural persons or where a natural person is represented by another natural person, the investment firm and the client should agree on how the relevant client information will be determined. As a minimum, information should be collected on the financial situation and investment objectives of the beneficiary(ies) of the investment advice or portfolio management services ('end client'), and on the knowledge and experience of the natural person (i) representing the entity or natural person(s), or (ii) authorised to undertake transactions on behalf of the entity or such persons ('representative').**

43. Where no representative has been appointed, as may be the case for a group of natural persons (for example, a married couple), investment firms should adopt a cautious approach by basing the suitability assessment on the person belonging to the group who has the lowest level of knowledge and experience.

**Q7: Do you agree that regarding client information for legal entities or groups, the investment firm and the client should agree on how the relevant client information will be determined and, as a minimum, information should be collected on the financial situation and investment objectives of the beneficiary of the investment advice or portfolio management services ('end client')? Please also state the reasons for your answer.**

### III.VIII. Arrangements necessary to ensure the suitability of an investment

**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, including his current portfolio of investments (and asset allocation within that portfolio), that is likely to be relevant in assessing whether an investment is suitable;**
- **all characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.**

44. 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.

45. 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.

46. Policies and procedures established by the firm should enable it to ensure inter alia that:

- (a) the advisory and portfolio management services provided to the client take into account an appropriate degree of risk diversification;
- (b) the client has an adequate understanding of the relationship between risk and return, i.e. he understands that the remuneration of risk free assets is necessarily low, and the impact of costs on his investments;
- (c) the financial situation of the client allows him to finance his investments at any moment and to bear any possible losses resulting from his investments;
- (d) any personal recommendation or transaction entered into in the course of providing a 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.

**Q8: Do you agree that in order to match clients with suitable investments, investment firms should establish arrangements to ensure that they consistently take into account all available information about the client and all characteristics of the investments considered in the suitability assessment? Please also state the reasons for your answer.**

III.IX. Record-keeping

**Investment firms should:**

- **maintain adequate recording and retention arrangements to ensure centralised, orderly and transparent record-keeping regarding all stages of the suitability process, 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.**

47. Record-keeping arrangements adopted by investment firms should be designed to enable firms to track ex-post how and 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, intended for the compliance officer or senior management, to identify risks of mis-selling.

48. Therefore, an investment firm should record all relevant information about the suitability assessment, such as information about the client (including how it interprets this information), and information about financial instruments accessible to the client (including any changes to the relevant information and the reasons for those changes).

**Q9: Do you agree that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment? Please also state the reasons for your answer.**

## Annex I

### List of questions

- Q1: Do you agree that information provided by investment firms about the services they offer should include information about the reason for assessing suitability? Please also state the reasons for your answer.
- Q2: Do you agree that investment firms should establish, implement and maintain policies and procedures necessary to be able to obtain an appropriate understanding regarding both the essential facts about their clients, and the characteristics of financial instruments available for those clients? Please also state the reasons for your answer.
- Q3: Do you agree that investment firms should ensure that staff involved in material aspects of the suitability process have the skills and the expertise to discharge their responsibilities? Please also state the reasons for your answer.
- Q4: Do you agree that investment firms should determine the extent of information to be collected about the client taking in to account the features of the service, the financial instrument and the client in any given circumstance? Please also state the reasons for your answer.
- Q5: Do you agree that investment firms should take reasonable steps (and, in particular, those outlined above) to ensure that the information collected about clients is reliable and consistent? Please also state the reasons for your answer.
- Q6: Do you agree that 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? Please also state the reasons for your answer.
- Q7: Do you agree that regarding client information for legal entities or groups, the investment firm and the client should agree on how the relevant client information will be determined and, as a minimum, information should be collected on the financial situation and investment objectives of the beneficiary of the investment advice or portfolio management services ('end client')? Please also state the reasons for your answer.
- Q8: Do you agree that in order to match clients with suitable investments, investment firms should establish arrangements to ensure that they consistently take into account all available information about the client and all characteristics of the investments considered in the suitability assessment? Please also state the reasons for your answer.
- Q9: Do you agree that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment? Please also state the reasons for your answer.

## **Annex II**

### **Cost-benefit analysis**

1. Article 16 of the ESMA regulation requires ESMA, where appropriate, to analyse the potential costs and benefits relating to proposed guidelines. It also states that cost-benefit analyses must be proportionate in relation to the scope, nature and impact of the proposed guidelines.
2. The purpose of the draft guidelines is to clarify the application of certain aspects of the current MiFID suitability requirements (arising from both MiFID and the MiFID Implementing Directive).
3. Gathering relevant information from a client about his investment objectives, financial situation, risk appetite and understanding is a key element in the provision of advisory services or discretionary portfolio management. Recent evidence indicates some weaknesses in the quality of client information obtained by firms before recommending an investment product, as well as weaknesses in suitability assessments.
4. By providing clarification of the relevant MiFID suitability requirements, ESMA is helping firms to improve their implementation of these requirements. Greater convergence leads to improved investor protection (consumer outcomes), which is a key ESMA objective.
5. The draft guidelines do not reflect any regulatory changes, neither do they purport to provide substantially new guidance relating to the applicable MiFID requirements. However, we expect the 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.
6. Given the limited scope, nature and impact of the proposed guidelines, ESMA considers that a full cost-benefit analysis is not required.

## Annex III

### Draft guidelines on certain aspects of the MiFID suitability requirements

#### I. Scope

1. These guidelines apply to investment firms, including credit institutions or UCITS management companies when providing investment services<sup>15</sup>, and competent authorities. They 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):

(d) investment advice;

(e) portfolio management.

2. These guidelines apply from [30] days after publication.

#### II. Definitions

3. 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	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.
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.
ESMA Regulation	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.
competent authority	An authority, designated by a Member State to carry out the duties provided for under MiFID (i.e. as designated under Article 48 of MiFID).

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<sup>15</sup> Only UCITS management companies providing individual portfolio management are covered by these guidelines.



### **III. Purpose**

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

### **IV. Compliance and reporting obligations**

#### **Status of the guidelines**

5. This document contains guidelines issued under Article 16 of the ESMA Regulation.<sup>16</sup> In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with guidelines.
6. 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**

7. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, by **[date]** to **[email address]**. A template for notifications is available from the ESMA website.
8. Financial market participants are not required to report whether they comply with these guidelines.

### **V. Guidelines on certain aspects of the MiFID suitability requirements**

#### **Information to clients about the suitability assessment**

##### *General guideline*

9. 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 during the suitability assessment process, or when informing clients, should investment firms create any ambiguity or confusion about their own responsibilities in the process.

##### *Supporting guidelines*

10. Information on investment advice and portfolio management services should include information about the suitability assessment.<sup>17</sup> This should help clients to understand the purpose of the requirements and encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation and investment objectives. Investment firms should highlight to the client

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<sup>16</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.

<sup>17</sup> '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.

that it is important to gather complete and accurate information so that the firm can recommend the most suitable product or service for the client.

11. Investment firms should take steps to ensure that the client understands the relationship between risk and return on investments, and should inform the client about how a risk profile is established.
12. The suitability assessment is the responsibility of the investment firm. In this regard, 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 his own risk profile (for example, by indicating to the client that a certain financial instrument is the one that the client chose as being suitable, or by requiring the client to confirm that an instrument or service is suitable).

### **Arrangements necessary to understand clients and investments**

#### *General guideline*

13. Investment firms should 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.

#### *Supporting guidelines*

14. Investment firms should establish, implement and maintain all policies and procedures (including appropriate tools) necessary to be able to understand those essential facts and characteristics.
15. Investment firms should know their clients. This means that firms should implement policies and procedures that enable them to collect, for example through questionnaires completed by their clients, and assess all information necessary to conduct a suitability assessment for each client. For example, in many cases it is unlikely that a firm will be able to meet its obligations if it is unaware of, or fails to consider, the client's age, marital status, family situation, employment situation, or need for liquidity in certain relevant investments.
16. 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 they understand the characteristics of the product, or financial instrument, involved.

### **Qualifications of investment firm staff**

#### *General guideline*

17. Investment firms should ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise.

#### *Supporting guidelines*

18. Staff should understand the role they play in the suitability assessment process and possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulations and procedures, to discharge their responsibilities.

19. Staff should have the skills necessary to be able to assess the needs and circumstances of the client. They should also have sufficient expertise in financial markets in order 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.

### **Extent of information to be collected from clients (proportionality)**

#### *General guideline*

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

#### *Supporting guidelines*

21. 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.
22. The extent of information collected may vary. This is because 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 (including the complexity and level of risk) of the financial instrument or transaction to be recommended or entered into;
  - (b) the nature and extent of the service;
  - (c) the nature, needs and circumstances of the client.
23. When providing access to complex (as defined in MiFID) or risky financial instruments, investment firms should bear in mind the need to collect more in-depth information about the client in order to be able to assess the client's capacity to understand, and financially bear, the risks associated with such instruments.
24. For example, for risky or illiquid financial instruments, the 'necessary information' to be gathered will include information on the length of time for which the client is prepared to hold the investment and may include all of the following elements with respect to his financial situation:
  - (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 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 ascertaining what financial commitments the client has made or will be making within a timeframe that would affect any investment the client wished to make (or that the firm wished to recommend or enter into in the course of providing a portfolio management service).
- 25. 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 advisory 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, it is reasonable to consider that the client's level of knowledge and experience 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 advisory service is to be provided. Nevertheless, even in such situations, the client 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.
- 26. Similarly, the extent of the service requested by the client may also impact the level of detail collected about the client. For example, firms would need to collect more information about clients asking for investment advice covering their entire financial portfolio than for clients asking for specific advice on how to invest a given amount of money.
- 27. An investment firm should also take into account the nature of the client when determining the information to be collected. For example, where a firm provides investment advisory 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.
- 28. Similarly, where the investment service consists in the provision of investment advice to a 'per se professional client' 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 will be required, 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.
- 29. Other elements regarding the nature of the client, such as age, family situation or educational level may also impact the level of information to be collected.
- 30. 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.

31. If an investment firm does not obtain sufficient information in order to be able to provide an advisory or portfolio management service that is suitable for the client, it must refrain from providing any such service to that client.<sup>18</sup>

### **Reliability of client information**

#### *General guideline*

32. Investment firms should take reasonable steps to ensure that the information collected about clients is reliable. In particular, firms should:
- (a) not rely on clients' self-assessment;
  - (b) ensure that all tools employed in the suitability assessment process are appropriately designed; and
  - (c) take steps to ensure the consistency of client information.

#### *Supporting guidelines*

33. Notwithstanding a client's responsibility to provide correct, up-to-date and complete information for the suitability assessment, investment firms should take reasonable steps to ensure the reliability of information collected about clients. This implies, amongst other things, that when collecting information about a client, investment firms should take care to ensure that the questions asked are likely to be understood.
34. For the same reason, investment firms should avoid relying unduly on the client's own assessment of his knowledge, experience and financial situation. 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 a client whether he believes he has sufficient funds to invest, the firm could ask the client for factual information about his financial situation;
  - (c) instead of asking a client whether he feels comfortable with taking risk, the firm could ask the client what level of loss over a given time period he would be willing to accept, either in the individual investment or on his portfolio.
35. Where investment firms rely on tools to be used by clients (such as on-line questionnaires, or risk-profiling software) as part of the suitability process, they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. Firms should also mitigate potential risks associated with the use of the tools. Potential risks may arise, for example, where clients (on their own initiative or where encouraged by customer-facing staff) change

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<sup>18</sup> See Article 35(5) of the MiFID Implementing Directive.

their answers in order to get access to financial instruments that may not be suitable for them; or where questions are drafted in a such way that they lead the client to a specific type of investment.

36. 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 contradictions between different pieces of information collected, and contact the client in order to resolve any potential inconsistencies or inaccuracies (such as little knowledge or experience and an aggressive attitude to risk, or a prudent risk profile and ambitious investment objectives).

### **Updating client information**

#### *General guideline*

37. 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 guideline*

38. Firms' procedures should define the minimum level of information required for each client and the information that is subject to updating, the circumstances to be taken into account in order to request additional or updated information (which may be specific to the type of client involved and service provided, and will involve an appropriate time period for updating), and the action to be taken by the firm (such as a change in the client profile) when additional or updated information is received or when the client fails to provide the information requested.

### **Client information for legal entities or groups**

#### *General guideline*

39. Where a client is a legal entity or a group of two or more natural persons or where a natural person is represented by another natural person, the investment firm and the client should agree on how the relevant client information will be determined. As a minimum, information should be collected on the financial situation and investment objectives of the beneficiary(ies) of the investment advice or portfolio management services ('end client'), and on the knowledge and experience of the natural person (i) representing the entity or natural person(s), or (ii) authorised to undertake transactions on behalf of the entity or such persons ('representative').

#### *Supporting guideline*

40. Where no representative has been appointed, as may be the case for a group of natural persons (for example, a married couple), investment firms should adopt a cautious approach by basing the suitability assessment on the person belonging to the group who has the lowest level of knowledge and experience.

### **Arrangements necessary to ensure the suitability of an investment**

#### *General guideline*

41. 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, including his current portfolio of investments (and asset allocation within that portfolio), that is likely to be relevant in assessing whether an investment is suitable;
- (b) all characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.

#### *Supporting guidelines*

- 42. 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.
- 43. 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.
- 44. Policies and procedures established by the firm should enable it to ensure inter alia that:
  - (a) the advisory and portfolio management services provided to the client take into account an appropriate degree of risk diversification;
  - (b) the client has an adequate understanding of the relationship between risk and return, i.e. he understands that the remuneration of risk free assets is necessarily low, and the impact of costs on his investments;
  - (c) the financial situation of the client allows him to finance his investments at any moment and to bear any possible losses resulting from his investments;
  - (d) any personal recommendation or transaction entered into in the course of providing a 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.

### **Record-keeping**

#### *General guideline*

- 45. Investment firms should:
  - (a) maintain adequate recording and retention arrangements to ensure centralised, orderly and transparent record-keeping regarding all stages of the suitability process, including any investment advice provided and all investments (and disinvestments) made;
  - (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*

- 46. Record-keeping arrangements adopted by investment firms should be designed to enable firms to track ex-post how and 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, intended for the compliance officer or senior management, to identify risks of mis-selling.
- 47. Therefore, an investment firm should record all relevant information about the suitability assessment, such as information about the client (including how it interprets this information), and information about financial instruments accessible to the client (including any changes to the relevant information and the reasons for those changes).