Guidelines

Confirmation of compliance with guidelines

Member/EEA State:	**Bulgaria**
Competent authority:	**Financial Supervision Commission**
Title of guidelines:	**Guidelines on certain aspects of the MiFID suitability requirements**
Name:	**Stoyan Mavrodiev**
Position:	**Chairman**
Telephone number:	**+359 2 9404 500**
Email address:	**mavrodiev_s@fsc.bg**

I am authorised to confirm compliance with the guidelines on behalf of my competent authority:

☒ **Yes**

The competent authority complies or intends to comply with the guidelines:

☒ **Yes** ☐ **No** ☐ **The guidelines do not apply**

My competent authority does not, and does not intend to, comply with the guidelines for the following reasons[1]:

The guidelines do not apply to my competent authority for the following reasons:

FINANCIAL SUPERVISION COMMISSION REPUBLIC OF BULGARIA

[1] In cases of partial compliance, please include the extent of compliance and of non-compliance. The fact that the competent authority does not intend to comply will be published. ESMA's Chair will decide whether to publish the reasons in accordance with the process established in ESMA's Board of Supervisors decision on the development of technical standards, guidelines and recommendations (ESMA/2011/BS/4a).

Final report

Guidelines on certain aspects of the MiFID suitability requirements

06 July 2012 | ESMA/2012/387

Contents

Acronyms

ESMA	European Securities and Markets Authority
EU	European Union
MiFID	Markets in Financial Instruments Directive
SMSG	Securities and Markets Stakeholder Group

I. Overview

1. ESMA's Consultation Paper (CP) 'Guidelines on certain aspects of the MiFID suitability requirements' (ref: ESMA/2011/445) was published 22 December 2011. The consultation period closed 24 February 2012.

2. ESMA received 52 responses (including from asset managers, banks, investment firm associations, trade associations, investor and consumer groups) - of which 6 were confidential responses.

3. In addition, ESMA received the Securities and Markets Stakeholder Group's (SMSG) 'Advice to ESMA' on that CP (dated 15 February 2012, ref: ESMA/2012/SMSG/11, and published on ESMA's website on 28 February 2012).

4. This final report sets out the feedback statement to the CP which provides an analysis of responses to the consultation (including the SMSG advice), describes any material changes to the technical proposals set out in Annex II (or confirms that there have been no material changes), and explains the reasons for this in the light of feedback received. This final report also includes the final guidelines.

Cost-benefit analysis (CBA)

5. Only one respondent commented specifically on the CBA (Annex I of the CP), saying that in the UK there is a set of standards (in force since 1988, with some improvements implemented by the Personal Investment Authority in 1995) that are fundamentally the same as the proposed ESMA guidelines. Accordingly, it is not expected that UK firms would face any significant additional on-going costs from implementation of the guidelines. However, there is likely to be some small one-off cost in relation to the implementation of the ESMA guidelines by the UK FSA and a review by all UK firms affected that their policies and procedures comply with any marginal changes that might be involved.

6. ESMA agrees, and considers that these small one-off costs are likely also to be incurred by other national competent authorities and EU firms. Nevertheless, ESMA considers that no changes need to be made to the CBA as set out in the CP.

Contents

7. Section II sets out the feedback statement.

8. Annex I sets out the advice of the SMSG; and Annex II contains the full text of the near-final guidelines.

Next steps

9. The guidelines in Annex II will be translated into the official languages of the European Union (EU), and published on the ESMA website. The application and reporting requirement dates set out in Annex II will start to run from date of publication of the translations.

II. Feedback statement

Guideline 1 (Question 1) - Information to clients about the suitability assessment

10. **We asked: "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**."

11. 45 respondents answered this question.

12. The vast majority of respondents (39 out of 45) supported fully or broadly the introduction of this guideline by ESMA.

13. One general comment in the responses was that in order for a client to be willing to provide the relevant information (e.g. about his/her financial situation), it is important that the client understands why the investment firm requests it. Respondents noted that many clients regard the request for information as 'intrusive', so more transparency on the topic would help the suitability process.

14. Several suggestions were received for improvements to the guidelines:

    - The guideline should be clear and unambiguous regarding the responsibilities of each party, both investment firm and client. The client should not be considered as totally passive in the suitability process. Intermediaries should not tolerate any ambiguity regarding its own responsibilities for conducting of the suitability test, however, clients must know that they are responsible for the information that they send. ESMA believes the guidelines are sufficiently clear on the topic and that no major changes to the proposed text are necessary.

    - Most respondents agreed that the information given to the client should not include the way a risk profile is established. This information (including math-content) could be too technical and incomprehensible for the client. It was also noted that only the basic assumptions of the risk profile setup, and its relation with the products, could be explained to and understood by most clients. ESMA has amended the guideline accordingly.

    - The guideline should not include the requirement for firms to recommend 'the most suitable product or service for the client' because this goes beyond current MiFID provisions. ESMA has changed the text from 'the most suitable product' to 'suitable products or services'.

    - One respondent stated that information produced by intermediaries, in accordance with the new guidelines, should be addressed specifically to retail clients, and not professional clients. ESMA has chosen to clarify in the Scope of the guidelines that "Although these guidelines principally address situations where services are provided to retail clients, they should also be considered as applicable, to the extent they are relevant, when services are provided to professional clients (MiFID Article 19(4) makes no distinction between retail and professional clients)".

15. A minority of respondents (6 out of 45) has significant reservations about the introduction of these guidelines since firms are already subject to detailed requirements regarding the suitability assessment process and these new obligations imply costs and do not improve investor protection levels. ESMA does not agree and considers that existing standards can, and should, be greatly improved. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.

Guideline 2 (Question 2) - Arrangements necessary to understand clients and investments

16. **We asked: "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**.

17. 53 respondents answered this question.

18. The majority of respondents (51 out of 53) agreed that 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.

19. Additionally, respondents noted that a consistent quality among all employees in contact with clients cannot be achieved if policies and procedures are not implemented. Respondents also appreciated that the guideline does not go into detail about the structure and content of such policies, helpfully allowing firms to tailor them to their client base.

20. Many respondents (11 out of 53) claimed that the examples of necessary information to be collected by investment firms (e.g. marital status, family situation) should be neither deemed exhaustive nor compulsory. The main reasons stated for this are possible conflicts with EU data protection regulation, no clear and direct link between some of the personal information required and the clients' investment objectives, costs related to the electronic handling of large amounts of information and the fact that the detailed requirements for client information gathering seem to go further than Article 19(4) of MiFID and Article 35(1) of the MiFID Implementing Directive. ESMA believes in the importance of firms maintaining adequate policies and procedures to understand the essential facts about their clients. ESMA has modified the text of the guideline to clarify that that information on the client's marital status, family situation and employment situation are only examples of the elements that impact the client's situation or investment need. The guideline has also been modified in order to better explain the proposed examples.

21. A couple of respondents (2 out of 53) stated that they do not agree on introducing guidelines on the topic because current regulation is appropriate and further requirements

are not necessary. ESMA considers that while the current legislation may be appropriate, recent evidence and supervisory experience (as noted in the CP) indicates that further guidance is required to ensure proper implementation and supervision of the current legislation. This, in turn, should also help to make compliance with the suitability requirements more consistent across the EU, thereby increasing the protection of investors.

Guideline 3 (Question 3) - Qualifications of investment firm staff

22. **We asked: 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**.

23. 40 respondents answered this question.

24. Respondents agreed almost unanimously on the fact that investment firms should ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise. Many noted that a similar requirement is already enforced by many national authorities and that professional staff training is common in many investment firms and should become standard across the EU. Additional clarifications and details were requested on what is meant by 'adequate level of knowledge', since it is possible that there will be some difference in application across national competent authorities. ESMA has made this clarification adding paragraph 28 on certification of staff.

Guideline 4 (Question 4) - Extent of information to be collected from clients (proportionality)

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

26. 47 respondents answered this question.

27. There is general support for the proposal regarding the need for proportionality between the information to be gathered from the client and the kind of services/products provided.

28. However, a number of respondents mentioned issues related to the topics addressed in the guidelines such as:

- The restriction of the requirement to those instruments defined as 'risky' or 'illiquid', which are categories that are not clearly defined in MiFID. ESMA has clarified that it is up to each investment firm to define *a priori* the level of risk of the financial instruments and which of the financial instruments included in its offer to investors it considers as being illiquid. Investment firms should take into account, where available, possible guidelines issued by competent authorities supervising the firm.

- Potential practical difficulties for investment firms in obtaining information regarding conditions, terms, loans, guarantees and other restrictions, especially if these products are provided by competing investment firms. ESMA has clarified that this information should be gathered only where relevant.

- On the topic of portfolio management, respondents agree on the principle, contained in the guidelines, that clients should be able to understand the overall risk of the portfolio. On the other hand, some respondents underlined that it seems unnecessary for the clients to understand the risk linked to each type of financial instrument that can be included in the portfolio. ESMA understands these concerns but has chosen to keep the proposed wording because a general understanding of the risk linked to each type of financial instrument is necessary to understand the overall risk of the portfolio.

Guideline 5 (Question 5) - Reliability of client information

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

30. 45 respondents answered this question.

31. 38 respondents agreed on the principles of the proposed guidelines. A number of respondents had reservations on a few specific topics:

    - Investment firms should not be held responsible if the client provides out of date, inaccurate or incomplete information. Respondents stated that the guidelines should require the investment firms not to question information provided in good faith by established clients unless there are good reasons to do so. ESMA has modified the wording of the guideline to state that investment firm must not 'unduly' rely on clients' self-assessment.

    - Use of the wording 'level of loss [the client is] willing to accept'. Whilst this indication of tolerance for losses is useful, it cannot guarantee that a given investment strategy designed in consequence and in good faith will always lose less than the tolerance level. ESMA has modified the guideline accordingly.

    - The obligation to 'resolve any potential inconsistencies' would lay an unrealistic burden on the investment firms. ESMA has specified that the obligation regarding potential inconsistencies concerns 'relevant' contradictions between different pieces of information collected.

Guideline 6 (Question 6) - Updating client information

32. **We asked: “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**.”

33. 39 respondents answered this question.

34. There is general consensus on the idea that firms should maintain adequate and updated information about a client. A general comment found in the answers is that these guidelines will need to be applied proportionally and with clear differences between retail and professional clients.

35. Some comments require clarifications and details on two aspects:

- If the new requirement is limited to the situations where there is an ‘ongoing relationship’ or to all clients. Respondents stated it would not be efficient or effective to maintain adequate and updated information about the client for whom the firm will not undertake any further work. ESMA further clarified that this guideline applies “When providing investment advice on an ongoing basis or the ongoing service of portfolio management”.

- If the guidelines are to be understood as imposing an obligation to perform ‘on-going assessment of the clients’ that would imply high costs and operational complexity. ESMA modified the text to clarify that this guideline concerns updating of client information in order to ensure that when an ongoing relationship exists, firms use updated information to perform the required suitability assessment.

Guideline 7 (Question 7) - Client information for legal entities or groups

36. **We asked: 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**.

37. 38 respondents answered this question.

38. The main topic raised, by 14 respondents, was related to the proposal that ‘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’. According to the responses received, this approach could:

- Significantly restrict the range of products and services available to the group and conflict with the group's investment objectives. Very often it is only the spouse with the greatest level of knowledge and experience who is in relation with the firm, while the other spouse is not involved in the relationship.

- Create compatibility issues with existing local legal requirements for joint accounts.

- Not be applicable in situations where an individual is legally appointed to act for another individual (e.g., in case of mental or physical incapacity).

- Not protect investors in the most efficient way.

39. Similar issues were raised by three respondents regarding investment firms' relationships with professional corporate clients. Respondents state that often a single assessment is made involving the Chief Financial Officer (CFO), who then allows or disallows a delegation of authority for placing orders to other people in the company.

40. In response to the issue described above, ESMA has modified the guideline to clarify that "Where a client is a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person, to identify who should be subject to the suitability assessment, the investment firm should first rely on the applicable legal framework. If the legal framework does not provide sufficient indications in this regard, and in particular where no sole representative has been appointed (as may be the case for a married couple), the investment firm, based on a policy it has defined beforehand by the firm, should agree with the relevant persons (the representatives of the legal entity, the persons belonging to the group or the natural persons represented) as to who should be subject to the suitability assessment and how this assessment will be done in practice, including from whom information about knowledge and experience, financial situation and investment objectives, should be collected. The investment firm should make a record of the agreement". ESMA has also modified the text of the supporting guidelines in order to clarify the topic.

Guideline 8 (Question 8) - Arrangements necessary to ensure the suitability of an investment

41. **We asked: "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**."

42. 42 respondents answered this question.

43. Many respondents agreed 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. However, the same respondents highlighted a

series of specific issues on some details of the proposed guidelines:

- Some respondents felt that the notion of 'all available information about the client' is larger than information that firms are legally required to collect for suitability purpose and goes beyond MiFID. Furthermore, some respondents stated that the obligation that would be placed on the investment firm to take into account in the suitability test all information regarding the client is inconsistent with paragraph 36, according to which the level of detail required by the investment service provider can vary, depending on the extent of the service provided to the client. ESMA does not consider this a valid concern and has not modified the guideline.

- Regarding the guideline's reference to the firm's obligation to verify that 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', respondents stated that both these points go beyond the MiFID requirements and could not be realistically applied by firms. ESMA has deleted 'at any moment' from the text of the guideline.

- Regarding the tools that firms use to assess suitability, a few respondents stated that the categorisation of client types/financial instruments is done upstream (in the firms' internal processes) and therefore it is unrealistic and disproportionate to consider that these matching tools should take into account the specificities of each client and financial instrument. ESMA does not deem it necessary to modify the text of the guideline because, as stated in paragraph 58, such tools should be 'fit for purpose and produce satisfactory results' and therefore need to take into consideration specificities of the different clients.

Guideline 9 (Question 9) - Record-keeping

44. **We asked: "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**."

45. 40 respondents answered this question.

46. The majority of respondents (34 out of 40) agreed that investment firms should establish and maintain record-keeping arrangements covering the suitability assessment with clients.

47. Respondents stated that record-keeping is an important instrument for a sound relationship with clients and a useful database that should be used to determine how to best assist them and that a similar requirement is already present is some jurisdictions.

48. At the same time, some respondents requested greater clarity in certain areas:

- 3 respondents queried why records need to be 'centralised' and asked what obligation is meant by this word. Some respondents stated that requiring firms to centralise all their client information systems goes beyond the scope of MiFID and is likely to cause costs which are disproportionate to the benefits obtained and could not be implemented within the timescales envisaged by ESMA for implementing the guidelines. ESMA has deleted the word ‘centralised’ from the guideline.

- The length of time for which firms should maintain their records should be specified. ESMA has amended the text to refer to Article 51 of the MiFID Implementing Directive.

Annex I

Advice of the Securities and Markets Stakeholder Group[1]

I. Executive summary

The Stakeholder Group supports the adoption of Guidelines related to MiFID and the overall approach of ESMA with respect to the Guidelines. However, it also makes a number of suggestions for revisions to enhance the Guidelines.

The Stakeholder Group supports the adoption of Guidelines on certain aspects of the MiFID suitability requirements and shares the overall approach of ESMA in the Guidelines. This issue is of high importance and recent experience shows that regulators regularly identify deficiencies in this area. Therefore the adoption of Guidelines should contribute effectively to enhancing consumer protection, which is one of the ESMA's objectives. The proposed Guidelines should also contribute to establishing a sound, effective and consistent level of regulation and supervision. However, the Stakeholder Group notes that a real and effective "consistent level" of investor protection regulation and supervision will only be achieved if the MiFID suitability provisions and ESMA Guidelines are extended to all other retail investment products. Currently, MiFID covers only a minority percentage of all investment products being offered and sold to individual investors in the European Union. Therefore, the Securities and Markets Stakeholder Group (SMSG) hopes that this consistency issue will be addressed by the upcoming initiative on Packaged Retail Investment Products (PRIPs) and Insurance Mediation Directive review proposals from the European Commission.

While strongly supporting both the timing and the content of the Guidelines, the Group would like to call the attention of ESMA to a number of specific elements which, in the opinion of the Group, could strengthen investor protection.

In general, Questionnaires should not be excessively relied nor used by investment firms to reverse the burden of proof. Live discussion and interaction between firm and client is the best method for understanding client needs.

With respect to the information which must be collected by the investment firm, there is a need to take a broader view and not to over-rely on a distinction between « risky and illiquid investments » and other investments.

The Group supports the requirement 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. In this regard, there is a very strong support within the Stakeholder Group that professional qualifications, such as the ones recently launched in the United Kingdom, in France

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[1] This SMSG advice is available to view on ESMA's website at: http://www.esma.europa.eu/content/Advice-Guidelines-certain-aspects-MiFID-suitability-requirements

and established since 2001 in Sweden should be strongly encouraged.

The distinction proposed between investment advisory services and portfolio management regarding the information to be collected by investment firms should not be given too much importance. On the contrary, there is an even greater need for protection of clients in case of discretionary advice. In the case of portfolio management services, this protection implies not just that the client "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" but that the investment firm also gain a very "clear understanding" and an "in-depth knowledge" of the profile of the client, of its psychology and of its investment strategy.

With respect to the "suitability" assessment, the Group believes that the Guidance places too much emphasis on "relevant risks". The concept of risk is very abstract and is, too often, subject to underestimation by investors and investment firms alike. The capacity of an investor to bear a permanent loss should instead be used (or at least to a similar extent) by investment firms. The loss-sustaining capacity of the investor should be considered carefully, and in a practical manner.

The age of the investor should be given more importance in view of recent major cases of mis-selling to elderly retail investors.

The guidelines need to emphasise that investment firms consider whether non-tradable products, and particularly basic deposit products, can satisfy the suitability requirement, depending on the circumstances.

Conflict of interest risk is particularly acute when investments are recommended or a portfolio is managed. Therefore, the Group suggests that the guidelines provide a more explicit explanation as to how conflicts of interest should be prevented. The guidelines currently makes simply a general comment on this point.

II. Explanatory remarks

1. On December 22, 2011 ESMA published a consultation paper relating to proposed Guidelines regarding the implementation of certain requirements of the Markets in Financial Instruments Directive (MiFID). The purpose of the Guidelines is to enhance clarity and foster convergence in the implementation of certain aspects of the MiFID requirements.

2. The first Guideline deals with the core issue of the MiFID "suitability" requirements (ESMA/2011/445). Article 19(4) of MiFID states that when providing investment advice or portfolio management services, investment firms 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 (or potential client) in question. The second Guidance (ESMA/2011/446), on MiFID's compliance requirements, is addressed in a second SMSG Report. The suitability Guidelines are divided between General Guidelines and Supporting

Guidelines. They deal only with certain aspects of MiFID.

3. The adoption of Guidelines by ESMA is subject to article 16 of the ESMA Regulation which provides that ESMA "shall, with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervisors (ESFS), and to ensuring the common, uniform and consistent application of Union law, issue Guidelines and recommendations addressed to competent authorities or financial market participants". Both Guidelines are addressed to competent authorities which are subject to the "comply or explain" approach imposed by article 16(3) of the Regulation. The Guidelines are also addressed to financial market participants. However, participants are not under a duty to report, "in a clear and detailed way, whether they comply with that Guideline... ".

4. The two Guidelines constitute new developments at the EU level. They do not duplicate previous work by the Committee of European Securities Regulators (CESR). However, they build on existing requirements developed by national regulators. The Guidelines on suitability requirements originate from evidence and concerns that "full and effective compliance with the MiFID suitability requirements is not as consistent or as wide-spread across EEA member states as it could or should be".

5. The Group supports the proposed Guidelines on suitability, but has some comments and would like to suggest some improvements on specific points.

III. General comments of the Group on Guidelines on certain aspects of the MiFID suitability requirements

III.I. Information to clients about the suitability assessment

6. The Group supports the requirement that the information provided by investment firms about the services they offer should include information about why and how suitability is assessed.

III.II. Arrangements necessary to understand clients and investments (Question 2)

7. 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. The Group has several concerns on this issue.

Paragraph 21 (No excessive reliance on questionnaires)

8. The Group is concerned that too much emphasis is being put on the use of questionnaire to the detriment of a physical meeting with a representative of the investment firm. A questionnaire is an essential tool in order to identify the investor’s profile. However, a questionnaire is also a very imperfect tool and is just a tool. Questionnaires have weaknesses. They are often long and complex, and are written in a technical language

which might not be easily understandable by most retail investors. Faced with complex questions on unfamiliar topics, retail investors are vulnerable to errors. Questionnaires can also have in-built flaws. Such flaws can result in inappropriate answers and interpretation of responses. Therefore, it is preferable to complete the questionnaire at a physical meeting with the investment firm, or at least a live discussion (e.g. phone) with the investment firm. This step would prevent misunderstanding of terms, either technical or plain-English terms which are subject to different interpretations by the investment firm and by the retail investor.

9. As a consequence, the Group is also especially concerned with internet-only questionnaires. Online questionnaires should not be encouraged and investment firms using these methods should be subject to increased supervision by competent authorities. In this situation also, live discussion between the client and the investment firm should be encouraged as much as possible.

10. In addition, when questionnaires are used, they should, when and as they deem appropriate and also to the extent possible in terms of costs, be tailor-made. However, some members of the Group consider that it is not possible to individually tailor make questionnaires

11. The Group also supports the use of all available information to assess the profile of the client, such as information from previous contractual relationships with the firm, or information which is publicly available. In addition, it should be clear that the responsibility for the suitability assessment should always remain with the investment firm, and should not be passed onto investors via these documents and systems.

12. The Group advises that the Guidelines include an explicit reference to the need for the investment firm to always exercise judgement and to take into account the human factor when dealing with clients or prospective clients.

Paragraph 23 (Possible products)

13. Paragraph 23 mentions that "Investment firms should also know the products they are offering." As to the type of investment which would be suitable, the Group considers that non tradable products and particularly basic cash deposits, may be the best advice in certain circumstances, given the risk profile and risk appetite of the investor or given the general economic outlook. Investment firms should look beyond proprietary products and tradable products generally. Cash deposits should be mentioned as suitable "investments" especially for customers which are unwilling or unable to accept the risk of loss of capital. Investors with large cash deposits should, as some bank defaults have been experienced in Europe, be informed of the level of deposit insurance in their jurisdiction.

Nature of the recommendation

14. Another issue which is of great concern to the Group is that the suitability test is too much focused on one financial instrument that could be recommended to the client. In many

cases, especially when first providing investment advice, investment firms tend to advise clients to reconstruct or to shift their portfolios. These portfolio reconstructions do not always lead to a new or different structure of the portfolio. However, the restructuration of the client portfolio leads to a portfolio turnover and potentially to high costs. The same risk lies with portfolio management services. Portfolio restructuration might constitute a perfectly suitable advice as such and should certainly not be discouraged since it is part of the duties to analyse an existing client portfolio. However, investment firms should at the same time be mindful of the cost of the restructuration.

15. As a consequence, the Group suggests extending the suitability test. Every recommendation must be suitable, whether it is a recommendation to buy, to hold or to sell.

Role of regulators

16. Competent authorities themselves can have a role in enhancing investor protection by providing market education. Local supervisors should be encouraged to assume a more active role in communicating to potential investors information about investing generally and what to look for when selecting financial instruments or when seeking investment advice/portfolio management services. However, investor education is no substitute to investor protection which remains the paramount goal of securities regulators.

III.III. Qualifications of investment firm staff

17. The Group supports the requirement 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. This is particularly the case given the complexity of certain products frequently sold to retail investors. This requirement cannot be underestimated by investment firms and might even be the most important in terms of investor protection.

18. However, such requirement should be applied in a sensible and cost effective way. Therefore, investment firms should not be subject to rules forcing them to hire experts which meet certain requirements. Employees engaged in this type of activity should be trained and qualified, but it should be clear that such training and qualification can also be acquired in the course of discharging their obligations, as well as through practical work and by means of training provided by the investment firm in a cost efficient way. Requirements of a formal nature, such as type of education, previous experience or training courses attended are an advantage, and professional qualifications, such as the ones launched recently in the United Kingdom, in France, and established since 2001 in Sweden should be strongly encouraged.

19. Members of the Stakeholder Group coming from Member States which have introduced such professional qualifications indicate that their view, as well as the one of their country financial industry, with the benefit of experience, is quite positive. For instance, Sweden has had since 2001 a compulsory certification of investment firm staff ("Swedesec Licence"). In France, a compulsory certification of investment firm staff, and

especially of sales persons, was established and entered into force in July 2010.[2] In France large banks had long been reluctant to such requirement but now they consider it as a real advantage. In the United Kingdom, a new national qualifications regime for advisers will come into force in 2013 as part of the Retail Distribution Review (RDR) launched in June 2006.[3] Despite concerns that large numbers of advisers would leave the industry, recent FSA reports show that the industry is moving over to the new qualifications regime and that while advisers are leaving, the numbers are not as great as expected, and, indeed, that parts of the industry support the higher standards.[4] A similar requirement exists in the US.

20. As another example, in Germany as of 31 October 2012 investment firms will have to instate investment advisors only if they are competent and reliable. These characteristics will have to be proved by the investment firms and have to be verified to the authority on their demand.

III.IV. Extent of information to be collected from clients (proportionality) (Question 4)

21. Before providing investment advice or portfolio management services, investment firms always need to collect "necessary information" about the client's knowledge and experience, financial situation and investment objectives (Paragraph 26). In general, the Group has some concerns with respect to the "proportionality" approach adopted by the Consultation paper.

Paragraph 27 (Proportionality at the start of the financial relationship)

22. Paragraph 27 mentions that "The extent of information collected may vary". This is so because investment firms should consider "(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." The Group is of the view that the necessary information should not vary depending on the type of the recommended financial instrument. This is so because recommendations cannot be given at the beginning of the advice process, but are given at the end of it. Therefore, the information collected from clients at the start of the process should be as complete as possible, and not be dependent on the potential instruments which may be the subject of subsequent advice.

Paragraph 29 (Proportionality as to the nature of the financial instrument)

23. The Group is very concerned that the ESMA Guidelines seem to identify "risky or illiquid financial instruments" only as requiring the collection of particular and detailed client information (Paragraph 29). There is a strong support from the Group that this distinction

[2] Art. 313-7-1 of the General Regulation of the Financial Markets Authority (*RGAMF*).

[3] On the RDR, See. http://www.fsa.gov.uk/about/what/rdr.

[4] Research: Progress towards the Professionalism requirements of the Retail Distribution Review, by Bryan Atkin, Naomi Crowther, Dominika Wintersgill and Andrew Wood, A research study for the FSA, 6 December 2011.

not be made, and that the relevant information noted in Paragraph 29 is collected in all suitability assessments. The financial crisis has shown that this distinction, although valid, might not always be easy to apply in real life situations. Therefore, the type of information mentioned in Paragraph 29 should also be collected (the exact extent on the circumstances, in cases relating to “non-risky and liquid investments”.

24. In addition, with respect to the extent of the “necessary information” to be collected on the “financial situation” of the client, the Group considers that the client’s debt burden must clearly be part of the information requested from the client. The Guidelines currently only refer to “financial commitments” (Paragraph 29(c)). Information on debt should be requested. It should include debits, the total amount of indebtedness and the monthly charge.

Paragraph 30 (Proportionality as to the nature of the service to be provided)

25. Before providing investment advice or portfolio management services, investment firms need to collect « necessary information about the client’s knowledge and experience, financial situation and investment objectives.[5] Paragraph 30 of the Guidelines, referring to article 35 of the MiFID Implementing directive[6], states that “In determining the information to be collected, investment firms should also take into account the nature of the service to be provided”. As a consequence, the Guidelines distinguish between investment advisory services and portfolio management services (discretionary advice). Where portfolio management services are to be provided, the Guidelines mention that "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" (Paragraph 30(b)).

26. The Group believes that the distinction proposed between investment advisory services and portfolio management regarding the information to be collected by investment firms, should not be given too much importance. The need for protection is just as strong in the case of portfolio management, or arguably even stronger due to the fact that decision making is transferred to the investment firm. Therefore, the distinction should not be interpreted as meaning a lower level of protection in case of portfolio management services.

27. In case of portfolio management services, the client cannot be expected to have the same degree of knowledge and experience as someone who is taking his own decisions. Therefore, a distinction is justified. However, the same level of protection cannot be

[5] Articles 19(1) and (4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.

[6] Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC.

achieved only by making sure that the client “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”. What is really needed is that the investment firm gain a very “clear understanding” and an “in-depth knowledge” of the profile of the client, of its psychology and of its investment strategy. Excellent understanding by the investment firm of the client is the key to making suitable investments.

28. In addition, in the case of portfolio management services, it is also essential to make sure that the client understands the risk profiles and financial implications of the products which a manager may make use of.

Paragraph 34

29. Regarding the extent of information to be collected, Paragraph 34 states that this includes “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. The SMSG does not think that "educational level" is a good criterion to identify the ability of clients to understand financial relations and concepts. Holding a PhD in natural sciences or in literature, or even an MBA, does not represent hard evidence of ability to understand complex financial instruments, certain types of risks or just the principles of basic investing. Even clients that have studied economics might still need basic advice and help regarding their financial decisions. The informative value of this criterion might therefore be limited in practice and we suggest that it be removed. Alternatively, the Guidelines could state that this criterion should not be taken into account unless specific circumstances apply.

III.V. Updating client information

31. As mentioned by the Guidelines, “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. Firms’ procedures should therefore define … the circumstances to be taken into account in order to request additional or updated information”. The Group would simply like to raise the issue of whether client information updating should remain at the discretion of investment firms, which is the current practice, or could take the form of formal ESMA Guidelines. This would provide a more consistent level of regulation but its possible content should also take into account the need not to overburden customers with too many requests.

III.VI. Arrangements necessary to ensure the suitability of an investment (Question 8)

Paragraphs 44-46 (Risk and loss sustaining capacity)

32. The Consultation Paper mentions that “In order to match clients with suitable investments, investment firms should establish policies and procedures to ensure that they consistently

take into account: … all characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client". This recommendation is part of the "General Guideline" of the Draft Guidelines themselves (Paragraph 41). Paragraph 46 adds that a list of "Policies and procedures established by the firm should enable it to ensure inter alia that: (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". Point (c) is part of the "Supporting Guidelines" of the Draft Guidelines themselves (Paragraph 44).

33. The Group considers that mentioning "all relevant risks" in the "General Guideline" is not enough to protect investors. Investors, and especially retail investors, tend to underestimate the level of risk that they are taking as well as their own risk absorbing capacity. They realize that there is risk in the proposed investment but they might not evaluate correctly the probability of the realisation of the risk in certain circumstances. Risk is an overly abstract concept to govern suitability. Investors might also act in an over confident way by considering that they are better than other investors at assessing risks and will do better. In addition, the investment firm itself, in good faith, might also underestimate the amount of risk which is being incurred by the client. The recent financial crisis provides painful proof that many financial institutions and banks, although experts in risk assessment and equipped with sophisticated software and analysts, might take risks to a degree that they incorrectly analyse or simply underestimate risk. Therefore, as a whole, the mere indication to the client of the existence of "relevant risks" is not enough to provide adequate protection.

34. A more effective approach is to focus on the capacity of the investor to bear losses, which is mentioned as a criterion in the "Supporting Guidelines". There is strong support within the Group for giving much more weight to this criterion. This implies that loss capacity be at least used as a criteria in the « General Guidelines » as it is more concrete and accessible to retail investors. The loss sustaining capacity of an investor should be considered carefully, and in a practical manner. It should not be considered in an abstract way as currently mentioned in the "Supporting Guidelines". Potential losses should be understood through concrete examples, in proportion to the amount to be invested. For example: such as "How would you cope permanently with losing 10,000 euros on your 50 000 euros investments?". In addition, rather than mentioning "possible losses", the Guidelines could refer to "permanent losses" or at least "long term losses" in order to highlight the reality of loss bearing. Otherwise, an investor might simply anticipate that she will recoup her losses quickly. Long term losses could possibly be described by mentioning a five year period or by reference to a given time frame provided by the client regarding the duration of his investment.

35. If any loss of capital would have a materially detrimental effect on the standard of living of an investor, this should be taken into account in assessing the risk that she is able to take. The investment firm should take into account not only the risk that the investor is willing

to take, but also the risk that she is able to take.[7]

Paragraphs 44-46 (age as a more specific criterion to ensure the suitability of an investment)

36. The criteria "age" is not mentioned specifically as a criterion to ensure the suitability of an investment. The Consultation Paper mentions that "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". This includes almost certainly "age". This is all the more that the Consultation Paper mentions the "age" of the investor as an information to be collected from clients (Part III.IV). Specifically, it mentions that "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" (Paragraph 22). It is also mentioned that "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" (Paragraph 34). However, the criterion of "age" is not singled out in the suitability assessment.

37. The Group notes that many issues of mis-selling concern elderly investors. For instance, a major case of mis-selling in the UK recently concerned customers who were typically in or near retirement.[8] While elderly people might be better investors than younger investors, or more cautious, the evidence shows that they can be also more fragile, less concerned by financial issues, or simply less experienced and aware of financial developments. Elderly investors also need more protection because they have less time to recoup losses, leaving them in a more difficult situation than younger investors. Finally, due to the current difficult situation with respect to public pension plans in Europe, there is a high probability that older people will look to invest their retirement savings to generate additional income in the coming years. Although investment firms would normally take the age of the investor into account, the Group is of the view that it would be wise to emphasise this criterion more strongly in the General Guidelines. For instance, the Draft Guidelines should also discuss age-related products, and in particular that the life span and investment objectives of a product make sense for the particular investor. A possible way to deal with the risks to of elderly investors would be to use a list of 'flags' which would trigger closer attention by the investment firm. If the advice seems not to fit with flag, then a second opinion from an higher hierarchical level within the investment firm might be required.

Paragraph 46 ("Conflicts of interest")

38. Paragraph 46 also mentions that "Policies and procedures established by the firm should enable it to ensure inter alia that: (e) any conflicts of interest are prevented from adversely

[7] See. FSA, Guidance consultation, Assessing suitability, Establishing the risk a consumer is willing and able to take and making a suitable investment decision, January 2011.

[8] See. FSA, Final Notice Barclays Bank Plc, 14th January 2011 available at *www.fsa.gov.uk/pubs/final/barclays_jan11.pdf*

affecting the quality of the suitability assessment”. This point is also part of the Supporting Guidelines.

39. The issue of conflict of interest is especially sensitive when recommending investments or managing a portfolio. Therefore, the Group suggests that the Guidelines provide a more explicit explanation on how conflicts of interest should be prevented, rather than confine itself to a general comment on this point. This very important point with respect to conflicts of interest should also be made clearer and more practical. In order to do so, ESMA should collect, through its consultation process, concrete suggestions to how these "conflicts of interests" can be prevented.

III.VII. Record-keeping

40. The Group supports in principle the requirement that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment. However, such a requirement would place an additional burden on investment firms in terms of administrative capacity (cost, personnel allocated, time and technology needed for making such records). The phrase “all relevant information” is, therefore, too broadly formulated and might suggest that a great mass of data is to be recorded and stored, while only essential information might be generally necessary to be kept for the purposes described in Section III.IX “Record-keeping”. One member of the Group suggested that, if so desired by the client, the investment firm should be able to avoid this obligation.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

Adopted on 15 February 2012

Annex II

Guidelines on certain aspects of the MiFID suitability requirements

I. Scope

Who?

1. These guidelines apply to investment firms (as defined in Article 4(1)(1) of MiFID), including credit institutions that provide investment services, UCITS management companies[9], and competent authorities.

What?

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

   (a) investment advice;

   (b) portfolio management.

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

When?

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

II. Definitions

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

Markets in Financial Instruments Directive (MiFID)	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, as

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

subsequently amended.

MiFID Implementing Directive	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

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

III. Purpose

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

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

IV. Compliance and reporting obligations

Status of the guidelines

9. This document contains guidelines issued under Article 16 of the ESMA Regulation.[10] In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants shall make every effort to comply with guidelines.

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

Reporting requirements

11. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for any non-compliance. Competent authorities must notify ESMA within two months of publication of the

[10] 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.

translations by ESMA to '**suitability.387@esma.europa.eu**'. In the absence of a response by this deadline, competent authorities will be considered non-compliant. A template for notifications is available on the ESMA website.

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

V. Guidelines on certain aspects of the MiFID suitability requirements

Information to clients about the suitability assessment

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

General guideline 1

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

Supporting guidelines

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

15. For the sake of clarity, firms are reminded that the suitability assessment is not limited to recommendations to buy a financial instrument. Every recommendation must be suitable, whether it is a recommendation to buy, hold or sell, for example.[11] Information about the suitability assessment should help clients to understand the purpose of the requirements and should encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation and investment objectives. Investment firms should highlight to the client that it is important to gather complete and accurate information so that the firm can recommend suitable products or services for the client. It is up to the firms to decide how they will inform their clients about the suitability assessment and such information can be provided in a standardised format. The format used should however enable *a posteriori* controls to check if the information was provided.

16. Investment firms should take steps to ensure that the client understands the notion of investment risk as well as the relationship between risk and return on investments. To enable the client's understanding of investment risk, firms should consider using indicative, comprehensible examples of the levels of loss that may arise depending on the

[11] See section IV of CESR, Understanding the definition of advice under MiFID, question and answers, 19 April 2010, CESR/10-293.

level of risk taken, and should assess the client's response to such scenarios. The client should be made aware that the purpose of such examples, and their responses to them, is to help determine the client's attitude to risk (their risk profile), and therefore the types of financial instruments (and risks attached to them) that are suitable.

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

Arrangements necessary to understand clients and investments

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

General guideline 2

18. Investment firms must have in place adequate policies and procedures to enable them to understand the essential facts about their clients and the characteristics of the financial instruments available for those clients.[12]

Supporting guidelines

19. Investment firms are required to establish, implement and maintain all policies and procedures (including appropriate tools) necessary to be able to understand those essential facts and characteristics.[13]

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

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

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

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

    (b) family situation (evolutions in the family situation of a client may impact his

[12] Adequate records about the suitability assessment should also be kept, as illustrated in guideline 9.

[13] Article 13(2) of MiFID.

financial situation e.g. a new child or a child of an age to start university);

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

(d) need for liquidity in certain relevant investments.

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

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

Qualifications of investment firm staff

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

General guideline 3

25. Investment firms are required to ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise.[14]

Supporting guidelines

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

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

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

Extent of information to be collected from clients (proportionality)

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

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

General guideline 4

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

Supporting guidelines

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

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

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

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

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

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

33. For example, when providing access to complex[15] or risky[16] financial instruments, investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex or risky instruments are at stake. This is so firms can assess the client's capacity to understand, and financially bear, the risks associated with such instruments.[17]

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[15] As defined in MiFID.

[16] It is up to each investment firm to define *a priori* the level of risk of the financial instruments included in its offer to investors taking into account, where available, possible guidelines issued by competent authorities supervising the firm.

[17] In any case, to ensure clients understand the investment risk and potential losses they may bear, the firm should, as far as possible, present these risks in a clear and understandable way, potentially using illustrative examples of the extent of loss in the event of an investment performing badly. A client's ability to accept losses may be aided by measuring the loss-sustaining capacity of the client. See also paragraph 16.

34. For illiquid financial instruments[18], the 'necessary information' to be gathered will obviously include information on the length of time for which the client is prepared to hold the investment. As information about a client's financial situation will always need to be collected, the extent of information to be collected may depend on the type of financial instruments to be recommended or entered into. For example, for illiquid or risky financial instruments, 'necessary information' to be collected may include all of the following elements as necessary to ensure whether the client's financial situation allows him to invest or be invested in such instruments:

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

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

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

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

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

(b) when portfolio management services are to be provided, as investment decisions are to be made by the firm on behalf of the client, the level of knowledge and experience needed by the client with regard to all the financial instruments that can potentially make up the portfolio may be less detailed than the level that the client should have when an investment advice service is to be provided. Nevertheless, even in such situations, the client should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio. Firms should gain a very clear understanding and knowledge of the investment profile of the client.

[18] It is up to each investment firm to define *a priori* which of the financial instruments included in its offer to investors it considers as being illiquid, taking into account, where available, possible guidelines issued by competent authorities supervising the firm.

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

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

38. Similarly, where the investment service consists of the provision of investment advice or portfolio management to a 'per se professional client'[19] the firm is entitled to assume that the client is able to financially bear any related investment risks consistent with the investment objectives of that client and therefore is not generally required to obtain information on the financial situation of the client. Such information should be obtained, however, where the client's investment objectives demand it. For example, where the client is seeking to hedge a risk, the firm will need to have detailed information on that risk in order to be able to propose an effective hedging instrument.

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

40. If an investment firm does not obtain sufficient information[20] to provide an investment advice or portfolio management service that is suitable for the client, it must not provide such service to that client.[21]

[19] As set out in Section I of Annex II of MiFID ('Categories of client who are considered to be professionals').

[20] 'Sufficient information' should be understood as meaning the information that firms must collect to comply with the suitability requirements under MiFID.

[21] See Article 35(5) of the MiFID Implementing Directive.

Reliability of client information

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

General guideline 5

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

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

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

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

Supporting guidelines

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

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

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

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

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

44. Where investment firms rely on tools to be used by clients as part of the suitability process (such as on-line questionnaires, or risk-profiling software), they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and

produce satisfactory results. For example, risk-profiling software could include some controls of coherence of the replies provided by clients in order to highlight contradictions between different pieces of information collected.

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

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

Updating client information

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

General guideline 6

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

Supporting guidelines

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

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

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

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

also trigger an updating process; this could be so, for example, for clients reaching the age of retirement.

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

Client information for legal entities or groups

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

General guideline 7

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

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

Supporting guideline

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

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

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

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

Arrangements necessary to ensure the suitability of an investment

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

General guideline 8

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

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

    (b) all material characteristics of the investments considered in the suitability assessment, including all relevant risks and any direct or indirect costs to the client.[22]

Supporting guidelines

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

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

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

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

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

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

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

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

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

Record-keeping

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

General guideline 9

61. Investment firms should at least:

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

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

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

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

Supporting guidelines

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

of the quality of a firm's suitability process, and may weaken the ability of management information to identify risks of mis-selling.

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

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

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