

**COMMISSION de SURVEILLANCE  
du SECTEUR FINANCIER**

In case of discrepancies between the French and the English text, the French text shall prevail

Luxembourg, 31 July 2007

To credit institutions, investment firms and management companies under Luxembourg law within the meaning of Chapter 15 of the law of 17 December 2010 as amended

**CIRCULAR CSSF 07/307**  
**as amended by Circulars CSSF 13/560, 13/568, 14/585**  
**and 23/841**

**Re: MiFID: Conduct of business rules in the financial sector**

Ladies and Gentlemen,

The purpose of this circular is to explain and specify certain provisions of the law of 13 July 2007 on markets in financial instruments transposing Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 (“the MiFID law”) and of Grand-ducal regulation of 13 July 2007 on the organisational requirements and conduct of business rules in the financial sector transposing Commission Directive 2006/73/EC of 10 May 2006 (“the Grand-ducal MiFID regulation”). **The provisions of this circular should be read together with the provisions of the aforementioned law and Grand-ducal regulation, which include the body of the requirements regarding the conduct of business rules applicable to the financial sector.**

This circular does not intend to deal exhaustively with all the requirements of the MiFID law and the Grand-ducal MiFID regulation. The specifications concern exclusively the scope (Chapter 1), general observations (Chapter 2), the responsibility of the board of directors and the authorised management (Chapter 3), external audit (Chapter 4), the categorisation of clients (Chapter 5), assessment of suitability and appropriateness (Chapter 6), conflicts of interest (Chapter 7), inducements (Chapter 8), best execution (Chapter 9), client order handling rules (Chapter 10), information to clients and potential

clients (Chapter 11), the need for a written agreement on rights and obligations of the parties (Chapter 12), the reports to provide to clients (Chapter 13), record-keeping (Chapter 14) and the rules to observe in specific competitive situations (Chapter 15).

The details provided in this circular with respect to Chapters 8, 9 and 14 are based on the recommendations published by the Committee of European Securities Regulators (CESR) appended to this circular.

The term “MiFID” refers in this circular to Directive 2004/39/EC and Directive 2006/73/EC, as well as to the MiFID law and the Grand-ducal MiFID regulation.

*The abbreviation “LFS” means the law of 5 April 1993 on the financial sector, as amended.*

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## **Chapter 1    Scope of application**

1. This circular addresses credit institutions and investment firms incorporated under Luxembourg law, including their branches established in another EU Member State, subject to point 5 below. Furthermore, this circular addresses Luxembourg branches of third-country credit institutions and investment firms.
2. Branches of credit institutions and investment firms of other EU Member States established in Luxembourg are concerned by this circular as well.

The competence fields as regards these branches for which the CSSF is responsible are the following:

- conduct of business rules (LFS art. 37-3);
- information to clients and potential clients (LFS art. 37-3);
- information on the client's profile (LFS art. 37-3);
- client data (LFS art. 37-3);
- reporting of services provided to clients (LFS art. 37-3);
- best execution and order handling (LFS art. 37-5 and 37-6; Grand-ducal MiFID regulation art. 45);
- obligation to preserve market integrity and transaction reports (MiFID law art. 28);
- pre- and post-trade transparency (MiFID law art. 26 and 27);
- right to examine the arrangements and require changes to the above obligations (LFS art. 45(4)).

The rules regarding conflicts of interests (Chapter 7) are laid down by the supervisory authority of the branch's home country. Although the CSSF's duties include enforcing the rules with respect to record-keeping (LFS art. 45(5)), branches shall comply with the relevant rules laid down by the supervisory authority of their home State.

3. This circular, as far as articles 13(3), 37-1 and 37-3 of the LFS are concerned, also applies to Luxembourg management companies within the meaning of Chapter 15 of the law of 17 December 2010 as amended, providing investment portfolio management, including those that are held by pension funds, on a discretionary and client-by-client basis, under a mandate given by investors, where these portfolios include one or several instruments listed in section B of Annexe II to the LFS. The term "institution" used in this circular refers to all entities covered by the MiFID law.

4. The conduct of business rules in the financial sector defined by the LFS and the Grand-ducal MiFID regulation also apply where services are provided or investment activities are performed by an institution incorporated under Luxembourg law within the territory of another EU Member State.
5. Branches of Luxembourg institutions established in another EU Member State must observe the conduct of business rules of the host State with respect to the services they provide within the territory of that State. Branches of Luxembourg institutions established outside the European Union must observe the relevant conduct of business rules of the host country.
6. Institutions that appoint tied agents must control their activities in order to ensure that the conduct of business rules in the financial sector are complied with. Within the meaning of the MiFID law, a tied agent is a person who, unlike business providers (“apporteurs d’affaires”), does not perform its tasks independently, but on behalf and under the full and unconditional responsibility of a sole institution. Institutions remain fully responsible for the actions of the tied agents acting on their behalf under a commercial agreement. Where an institution appoints a tied agent established in another EU Member State, this tied agent is subject to the provisions of this circular and of the relating MiFID rules that govern branches.

## **Chapter 2    General comments**

7. The new article 37-3(1) of the LFS requires institutions, when providing investment services to clients, and, where applicable, ancillary services, to act honestly, fairly and professionally in the best interest of the clients. This general principle had already been the key principle of the professional requirements introduced in 1998 in article 37 of the LFS. As the purpose of the principles underlying the conduct of business rules of the former article 37 of the LFS and of those underlying the conduct of business rules of MiFID is the same, MiFID regulations confirm the general approach applied since this date by the institutions in the financial centre. The provisions of this circular are the natural continuation of circular CSSF 2000/15 published in application of former article 37.
8. The general principle of article 37-3(1) of the LFS guides institutions in implementing the rules laid down in the MiFID law and the Grand-ducal MiFID regulation. The different elements of the conduct of business rules in the financial sector set out in the MiFID law and Grand-ducal MiFID regulation, such as the conflicts of interest requirements, inducements, best execution or client information, shall not be considered separately, but as elements interconnected by the obligation to act in the clients' interests.
9. The obligation to act honestly, fairly and professionally in the best interest of the clients covers the more specific rules that have been laid down in circular CSSF 2000/15, some of which have not been included in the MiFID law or Grand-ducal MiFID regulation, but which clearly stem from the obligation to act honestly, fairly and professionally in the best interest of the clients.
10. The professional shall ensure that the client is not dependent on the employee in charge of his affairs and particularly that the client relationship does not become the sole responsibility of a single employee.
11. Institutions observing that one of their employees or tied agents breaches or attempts to breach the rules shall immediately take appropriate measures and, according to the seriousness of the situation, inform the CSSF.
12. Where a client files a complaint with an institution with respect to a service provided, the institution shall deal with such complaint in an appropriate manner and within a reasonable timeframe according to the nature of the problem, in accordance with circular IML 95/118.

### **Chapter 3      Responsibility of the board of directors and the authorised management**

References:

LFS: Art. 37-1

Grand-ducal MiFID regulation: Art. 6 to 9

#### **3.1 Responsibility of the board of directors**

13. The board of directors is responsible for setting down policies and procedures allowing compliance with the provisions of the MiFID law and Grand-ducal MiFID regulation, as well as with this circular.

In concrete terms, the board of directors:

- decides on efficient risk management policies and procedures (proposed by the authorised management and developed by the risk management function) allowing to identify the risks relating to the institution's activities and services, processes and systems, and, where appropriate, to set the level of risk tolerated by the institution;
  - asks the authorised management to adopt efficient provisions, processes and mechanisms to manage risks linked to activities and services, processes and systems in light of the institution's level of risk tolerance;
  - asks the authorised management to set up a risk management function that operates independently, where appropriate and proportionate with the nature, scale and complexity of the institution's business and the nature and range of the institution's investment services and activities.
14. Within the scope of its supervisory mission, the board of directors shall make sure, on a regular basis, that the institution has in place appropriate policies and procedures. This supervision can be made *via* reports that the authorised management must submit in accordance with point 18.

#### **3.2 Responsibility of the authorised management**

15. The institution's authorised management is responsible for implementing the policies and procedures set up by the board of directors and relating to the provisions of the MiFID law and Grand-ducal MiFID regulation, as well as to this circular. The policies and procedures shall be laid down in writing. The authorised management shall ensure the correct application of these policies and procedures. It shall appoint one of its members as responsible for the conduct of business rules in the financial sector and communicate the name of this person to the CSSF by 31 December 2007, as well as any subsequent change thereto.



16. The authorised management shall inform the relevant personnel of the policies and procedures required by the MiFID law and Grand-ducal MiFID regulation, as well as by this circular, and any change thereto.
17. The authorised management defines the human and technical resources to be implemented to ensure the correct application of the policies and rules. It ensures that compliance with these policies and relevant procedures is checked by its compliance function and its internal audit function on a regular basis. To this end, it requires that written reports are submitted by the aforementioned functions on a regular basis and at least once a year. In particular, these reports shall describe the deficiencies observed, the corrective measures taken and the follow-up on these measures.

The authorised management shall ensure that a report on the functioning of risk management is drawn up on a regular basis and at least once a year in the context of its critical monitoring of the policies and procedures in accordance with point 13.

18. On a regular basis, and at least once a year, the authorised management submits reports on the issues covered by the internal audit function, the compliance function and, where required, the risk management function, to the board of directors.
19. The institutions must communicate to the CSSF a copy of the reports referred to in point 18.

### 3.3 Specifications concerning the risk management function, the compliance function and the internal audit function.

20. The purpose of the risk management function as defined in point 13 above is to:
  - define and implement the policies and procedures referred to above;
  - perform a critical follow-up on the policies and procedures, draw up reports for the authorised management in this area and to advise the latter.

If the function does not have its own resources, the tasks pertaining to risk management can be performed by the authorised management itself or by persons specifically appointed by the authorised management, in compliance with the principle of segregation of duties and independence.

It should be borne in mind that the compliance function's mission is to identify and assess the institution's risk of not complying, while performing its activities, with the provisions of the MiFID law, the Grand-ducal MiFID regulation, this circular and the rules and procedures that the institution has set up under its risk management policies.

“For management companies, Circular CSSF 04/155 (on the compliance function) and Circular IML 98/143 (on internal control and internal audit) remain fully applicable. For credit institutions and investment firms, the

provisions of Circular CSSF 12/552 on internal control, including internal control functions, shall apply.”<sup>1</sup>

21. Where it is not appropriate and proportionate with the nature, scale and complexity of the institution’s activities, and with the nature and range of the institution’s investment services and activities, to set up an independent risk management function as referred to in point 13, the board of directors shall however ensure that measures be taken to enable the institution to manage risks efficiently.

## **Chapter 4 External audit**

22. The long-form report to be drawn up by the external auditor pursuant to circulars CSSF 01/27 and 03/113 shall include an appraisal of the rules set up in accordance with this circular and their implementation. The report shall also state the member of the authorised management responsible for the conduct of business rules in the financial sector, as well as any change concerning the person concerned. The first report that must take this into account is the report accounting for the financial year closing after 30 September 2008.

## **Chapter 5 Categorisation of clients**

### References:

LFS: Art. 37-7 and Annexe III

Grand-ducal MiFID regulation: Art. 33 and 59

### 5.1 General comments

23. MiFID provides that the conduct of business rules shall be applied according to the type of client, i.e. a distinction is made between retail clients, professional clients and eligible counterparties.
24. Retail clients benefit from a higher level of protection than professional clients, who are supposed to have, for the types of investment services in respect of which they have been categorised as being professional clients, the necessary experience, knowledge and expertise to make their own investment decisions and properly assess the risks they incur. In assessing the experience and knowledge of the client, the institution may take into account the information and warnings in relation to the risks inherent in the financial instruments concerned it has provided to its clients.

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<sup>1</sup> Circular CSSF 13/568

25. The denomination “retail clients” adopted by MiFID does not call into question the terminology used by the institutions to refer to their non-professional clients. Institutions are free to use alternative terms such as “individual clients” or “private clients” in their communications with clients.
26. MiFID introduces another category, i.e. eligible counterparties, to whom certain protections do not apply (please refer to section 5.4).
27. MiFID allows for changes in categories provided that certain conditions are met. Where a client requests to be classified in another category, either generally or in respect of a particular transaction, the institution has the choice of providing the service on this new basis.
28. The institution must inform the client, in a durable medium, about the right the client has to request a different categorisation and about any limitations to the level of client protection that it would entail. The notion of durable medium is defined in article 2 of the Grand-ducal MiFID regulation. Under certain conditions laid down in article 3 of that regulation, a website may be a durable medium.
29. In application of the provisions of Annexe III to the LFS, institutions must have in place appropriate written internal policies and procedures to categorise clients.
30. Nevertheless, in order to simplify their internal management, institutions may decide to treat all clients as retail clients, in accordance with article 33(3) of the Grand-ducal MiFID regulation.
31. Institutions that fulfilled the criteria set up by FESCO (The Forum of European Securities Commission), included in the annexe to circular CSSF 2000/15, to determine whether a client is a professional client, may keep this categorisation for professional clients under MiFID without needing to review every single case. Point 2 of Annexe III, section B of the LFS specifies that the categorisation of clients already categorised as professionals is not affected as long as it was made according to criteria and procedures similar to those laid down by MiFID.
32. Institutions may automatically categorise existing non-professional clients as retail clients under MiFID without having to inform the clients on their categorisation.
33. The Grand-ducal MiFID regulation (art. 33(1)) specifies that the new clients and those whose category has changed must be informed on their category.

## 5.2 Retail clients

34. The category of retail clients includes by default all the persons that do not meet the criteria defining professional clients and eligible counterparties. These clients are afforded an additional level of protection compared to professional clients, in particular owing to the fact that institutions must

provide detailed information on the financial services and instruments offered and owing to the obligation imposed on institutions to assess the clients' knowledge, experience and expertise before providing investment services.

### 5.3 Professional clients

35. The protection provided to professional clients takes into account the knowledge and experience that such clients have in general with respect to the investment services they request or are being offered. Consequently, these clients are able to decide on their own which information they need to take their decisions on an informed basis.
36. The category of professional clients includes the professionals automatically considered as such, as well as the clients who may be treated as professionals on request.
37. Annexe III, section A of the LFS provides for identification criteria for the first category of professionals, i.e. the professionals "per se". These criteria remain almost unchanged compared to those provided in circular CSSF 2000/15. They differ in that undertakings that reach a certain threshold in terms of balance sheet total, own funds or turnover are henceforth automatically considered to be professional clients, while under circular CSSF 2000/15, large undertakings could only be treated as professionals on their own request.
38. The second category of professionals "on request" includes those clients that may be allowed to waive some of the protections offered by the conduct of business rules. Such categorisation shall be considered valid only if the institution has assessed that the knowledge, experience and expertise of the client gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved. Professional clients "on request" should not be presumed to possess market knowledge and experience comparable to professional clients "per se". The MiFID law introduces with Annexe III, section B of the LFS criteria allowing to assess the fulfilment of this condition (mainly the same as those defined in circular CSSF 2000/15). As a minimum, two of the following criteria must be satisfied:
  1. the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous 4 quarters;
  2. the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;
  3. the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

39. Unlike professionals “per se”, professionals “on request” shall state in writing to the institution that they wish to be treated as professionals, either generally or in respect of a particular investment service or transaction, and state in writing, in a separate document from the contract, that they are aware of the consequences of waiving protections. The institution shall clearly state the protections that the client may lose, such as information he will no longer receive automatically and the assessment of appropriateness that will no longer be performed.
40. As regards the updating of the categorisation of professional clients, MiFID stresses that it is up to the clients to inform the institution on any change.

#### 5.4 Eligible counterparties

41. Institutions authorised to (1) execute orders on behalf of clients, (2) deal on own account or (3) receive and transmit orders, may bring about transactions with eligible counterparties or enter into transactions or any ancillary service related to those transactions between eligible counterparties. This concerns any credit institution, as well as any investment firm except for investment firms operating an MTF in Luxembourg and investment advisors. If it is not within one of the aforementioned exceptions, the institution may thus act as “principal” and be itself a counterparty to the transaction, or act as “agent” and bring about transactions between two eligible counterparties.
42. All investment firms without exception may however constitute an eligible counterparty. Article 37-7(2) of the LFS lists the professionals that are treated as eligible counterparties. Third-country counterparties equivalent to these categories may also be considered as eligible counterparties.
43. When dealing with eligible counterparties, institutions are exempted from the application of articles 37-3 (conduct of business rules), 37-5 (best execution) and 37-6(1) (client order handling rules) of the LFS in relation to the services referred to in point 41. However, given the fact that eligible counterparties are supposed to act as clients, the other provisions of MiFID remain applicable.
44. In addition, in accordance with article 59(1) of the Grand-ducal MiFID regulation, the professional clients “per se” shall be considered as eligible counterparties under client categories 1, 2 and 3 of Annexe III, Section A of the LFS.
45. An institution may consider a professional client “on request”, who fulfils the criteria laid down in Annexe III, Section B of the LFS, as eligible counterparty, provided that it is an undertaking. A natural person or any other person that is not an “undertaking” shall on no account be treated as an eligible counterparty. An undertaking may be considered as eligible counterparty solely for services or transactions for which it is also treated as professional client. A professional client on request shall confirm expressly

to be treated as an eligible counterparty and to waive some of the protections. This confirmation may be general or specific to an individual transaction. Moreover, an institution may refuse to grant the status of eligible counterparty to a professional client on request, either in general or related to a certain type of transactions.

46. Clients categorised as eligible counterparties may request the protection provided for in articles 37-3, 37-5 and 37-6 of the LFS, whether in a general form or on a trade-by-trade basis. This option is particularly important for eligible counterparties that act on behalf of their clients and that are therefore under the obligation to act in the best interest of their clients laid down in article 37-3(1) of the LFS.

## **Chapter 6     Assessment of suitability and appropriateness**

### References:

LFS: Art. 37-3(4), 37-3(5) and 37-3(6)

Grand-ducal MiFID regulation: Art. 40 to 45

### 6.1 Suitability test

47. Article 37-3(4) of the LFS and article 41(2) of the Grand-ducal MiFID regulation require that institutions, when providing investment advice or portfolio management, take into account the knowledge and experience of the client in the investment field, his financial situation and his investment objectives so as to recommend to the client the investment services and financial instruments that are suitable for him (“suitability test”). When performing discretionary management services, this information shall be obtained at the beginning of the relationship with the client in order to define the type of products that suit the client.
48. This principle is in line with the professional obligation laid down in the former article 37 of the LFS, i.e. to obtain information on the financial situation, investment experience and investment objective of the client for the services requested.
49. The Grand-ducal MiFID regulation details the content of the information to obtain from the client as far as his financial situation (art. 41(4)) as well as his investment objectives (art. 41(5)) are concerned. Article 43(1) of this regulation lists the information that must be obtained so as to assess the client’s experience and knowledge. The Grand-ducal MiFID regulation requires that institutions obtain from their clients and potential clients the necessary information to understand the essential facts about the clients and to have a reasonable basis for believing, given due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of providing a portfolio management service fulfils the three criteria of point 48.
50. The level of detail of the information required to assess suitability may vary according to the type of service or financial instruments that are being offered.

A transaction may be unsuitable for the client because of the risks inherent in the financial instruments concerned, the type of transaction, the characteristics of the order or the frequency of the trading. In the case of portfolio management, a transaction might also be unsuitable if it would result in an unsuitable portfolio.

The institution shall refrain from carrying out on its own initiative transactions for its clients that are unnecessary or contrary to the interest of

its clients. Neither shall it execute transactions that, given their frequency and volume, may be considered as solely in its own interest.

51. Article 43(3) of the Grand-ducal MiFID regulation specifies that the institution is entitled to rely on the information provided by its clients or potential clients, unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.
52. Within the scope of a suitability test, institutions may rely on information transmitted by another institution where they receive an instruction from the latter to perform investment or ancillary services for a client. In this event, the investment firm which mediates the instructions will remain responsible for the completeness and accuracy of the information transmitted.
53. Under its own responsibility, an institution may rely on information transmitted by non-EU institutions as far as it made sure that these institutions are submitted to MiFID-equivalent rules in terms of suitability. Likewise, an institution may rely on the suitability test performed by another institution. Where this test was performed by an institution of a third country, the institution must make sure that this test was carried out according to suitability criteria equivalent to those laid down in article 37-3(4) of the LFS.
54. Where the institution does not receive the necessary information to assess whether the investment service or the financial instrument concerned suits the client, it shall not recommend it to the client. When performing discretionary management services, institutions shall refrain from recommending a certain type of services to a client where relevant information is lacking.

#### Professional clients

55. Institutions may presume that professional clients have the necessary experience and knowledge. Where the client concerned is not categorised as professional for all services, products or transactions, this presumption is only valid for those products, services and transactions for which he is categorised as professional.
56. Where an institution provides investment advice to a client categorised as professional “per se”, it may suppose that the client is financially in a position to support any risk linked to the investment compatible with his investment objectives. In this case, the institution only assesses whether the recommended transaction meets the investment objectives of the client concerned. Where the institution provides investment advice to a client considered to be a professional “on request”, the institution shall assess the fulfilment of the client’s objectives, as well as his financial capacity to bear the risks linked to the transaction. This latter obligation also applies to clients categorised as professionals “per se” and as professionals “on request” under discretionary portfolio management.



## 6.2 Assessment of appropriateness and execution only

57. If the investment service provided is a service other than investment advice or portfolio management, institutions shall assess, in accordance with article 37-3(5) of the LFS, whether the client has the appropriate experience and knowledge to understand the risks inherent in the product or investment service offered or requested.
58. Appropriateness tests of the service to provide are not required in a certain number of situations:
- (a) Clients categorised as professionals for a certain service or product, either automatically or on request, are presumed to have the necessary knowledge and experience to understand the risks inherent in this product or service. »Consequently, the institution is no longer obliged to perform an appropriateness test in such situations.
  - (b) «According to article 37-3(6) of the LFS, where the investment service concerned consists in executing and/or receiving and transmitting client orders and where certain other conditions are fulfilled, the institution is not obliged to assess the appropriate character of the service (“execution only”). The service must be provided at the initiative of the client and must relate to the financial instruments listed in the first indent of article 37-3(6) of the LFS or other non-complex financial instruments. Although it does not provide an exhaustive list of non-complex instruments, article 44 of the Grand-ducal MiFID regulation proposes certain criteria. For services rendered on an execution-only basis, the institution must clearly inform the client that it is not required to assess appropriateness. This warning may be provided in a standardised format.
  - (c) For a set of transactions involving the same type of service and product, the institution is not required to re-assess appropriateness for every separate transaction.
  - (d) Finally, clients who enter into transactions involving a particular type of service or product before 1 November 2007 are presumed to have the necessary experience and knowledge to understand the risks involved in relation to that product or investment service. The institution is therefore not obliged to perform an appropriateness test for services already provided to the client in the past.
59. Where the institution is required to assess appropriateness, it may take into account information and warnings on the risks linked to financial instruments it has provided to its client pursuant to article 36 of the Grand-ducal MiFID regulation.
60. Unlike the suitability test that prohibits institutions to recommend a product that does not suit the client, the institution may execute the envisaged

transaction even if it is not appropriate for the client. Nevertheless, it must warn the client that it considers that the product or service concerned is not appropriate.

61. Likewise, the institution may execute a transaction even if the client does not provide the necessary information to apprehend the appropriateness of the product or service. In this event, it shall inform the client of that fact. In order to limit this type of situations, article 43(2) of the Grand-ducal MiFID regulation specifies that the institution shall not encourage the client not to provide the required information.

## **Chapter 7 Conflicts of interest**

### References:

LFS: Art. 37-1(2) and 37-2

Grand-ducal MiFID regulation: Art. 23 to 26

### 7.1 General comments

62. An institution shall take all reasonable steps to identify potential conflicts of interest between the interest of the institution (including its managers, employees and, where applicable, its tied agents) and its duties owed to its clients, as well as between differing interests of two or more of its clients, to each of whom the institution owes specific duties. This requirement is an obligation of means, not of results.
63. Where the organisational and administrative provisions that have been taken are not sufficient to ensure that the interests of the clients are not damaged, the institution shall, before acting on behalf of the client, disclose to the latter the nature, and, where applicable, the source of the remaining conflict of interest. This communication may be of a general nature.
64. Article 24 of the Grand-ducal MiFID regulation sets out five situations that can generate potential conflicts of interest:
- (a) the institution is likely to make a financial gain, or avoid a financial loss, at the expense of the client;
  - (b) the institution has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;
  - (c) the institution has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;
  - (d) the institution carries on the same business as the client;

- (e) the institution receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service (see Chapter 8).

## 7.2 Conflicts of interest policy

- 65. The institution shall establish a conflicts of interest policy set out in writing and appropriate to the size and organisation of the institution and the nature, scale and complexity of its business. This policy shall in particular identify the circumstances that give rise or may give rise to a conflict of interest entailing a material risk of damage to the interests of the client. Furthermore, it shall provide for procedures to be followed and measures to be adopted in order to manage such conflicts of interest.
- 66. The disclosure of conflicts of interest should not exempt the institution from its obligation to maintain and operate organisational and administrative arrangements (art. 37-1(2) of the LFS).

## **Chapter 8 Inducements**

### References:

LFS: Art. 37-3

Grand-ducal MiFID regulation: Art. 30

## 8.1 General provisions and scope

- 67. MiFID provides for rules governing inducements that have a larger scope than those of circular CSSF 2000/15, which only provided for information to the client on retrocessions received by another professional for the transmission of orders to this professional on behalf of the client.
- 68. Indeed, article 30 of Grand-ducal MiFID regulation provides that for considering fees, commissions or non-monetary benefits paid to or received by an institution with respect to an investment service as acceptable, they must be designed to enhance the quality of the relevant service and be disclosed to the client. Moreover, the benefits paid to or received by an institution must not impair compliance with the institution's duty to act in the best interest of the client.
- 69. Two types of inducements are exempted from fulfilling these conditions: on the one hand, the inducements paid or provided to or by the client, or to or by another person on behalf of the client (art. 30(a) of the Grand-ducal MiFID regulation). On the other hand, fees that allow the provision of investment services or are necessary to provide them and which, by their

nature, cannot give rise to conflicts with the duty to act honestly, fairly and professionally in accordance with the best interest of the clients (art. 30(c) of the Grand-ducal MiFID regulation). Nevertheless, these exemptions only apply in a restricted number of situations.

70. Thus, for an inducement to be considered as having been paid by a person on behalf of a client, this person must act as a simple payment conduit on the client's instruction. The fact that the cost of an inducement paid by the institution is borne by the client is not sufficient for it to be considered to be made on behalf of the client. A situation where a product provider retrocedes part of the fees received to another firm (e.g. a distributor of these products) shall always, as a matter of principle, be dealt with in accordance with article 30(b) of the Grand-ducal MiFID regulation.
71. Moreover, although the list of relevant fees provided in article 30(c) is not exhaustive (custody costs, settlement and exchange fees, regulatory levies or legal fees), the scope of article 30(c) of Grand-ducal MiFID regulation is highly limited through the condition that such fees may not, by their nature, give rise to conflicts with the duty to act honestly, fairly and professionally in accordance with the best interests of the clients. Retrocessions of commissions to a distributor of financial products cannot be accepted as appropriate fees under article 30(c), even if they legitimately remunerate services allowing clients to have access to products, and are thus subject to the requirements of article 30(b).
72. Payments made between legal entities pertaining to the same group are governed by article 30.

## 8.2 Inducements designed to enhance the quality of the service

- 73. Article 30(b)(ii) of the Grand-ducal MiFID regulation provides that the payment of a fee, commission or the provision of a non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the institution's duty to act in the best interest of the client.
- 74. This condition does not imply that the quality of the service must be enhanced for each individual client for each service provided. A general enhancement of the quality of a service offered to a group of clients may generally be considered as sufficient.
- 75. Fees paid to third parties who are necessary for the provision of services may be considered as enhancing the quality of the service to the client. For instance, commissions received by a distributor of financial products as a remuneration of distribution services provided may be considered as enhancing the quality of the service to the client as it allows the client an easier access to these products than in the absence of a distribution network.
- 76. Recital 39 of Directive 2006/73/EC specifies that fees received in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased, should be considered as designed to enhance the quality of the investment advice to the client.
- 77. For the purpose of assessing whether other inducements received or paid comply with article 30(b), institutions are invited to refer to the examples and criteria proposed in Recommendation 4 of the CESR Guidelines (cf. Annexe I).

## 8.3 Information to be disclosed to clients

- 78. In accordance with article 30(b)(i) of the Grand-ducal MiFID regulation, institutions must clearly inform the client on the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount.
- 79. This information must be provided prior to the provision of the relevant investment or ancillary service.
- 80. Nevertheless, institutions are allowed to disclose the main terms of the arrangements relating to the inducements paid or received in a summary form, provided that they undertake to disclose further details at the request of the client. It has not been specified what exactly this summary disclosure must contain, but it must be sufficiently detailed and comprehensible so as to allow the client to take an informed decision whether to proceed with the investment service.

81. This disclosure requirement only applies to the institution that deals directly with the final client and is not applicable to the inducements paid or received between other intermediaries of the distribution channel.

## **Chapter 9 Best execution**

### References:

LFS: Art. 37-5

Grand-ducal MiFID regulation: Art. 51 to 54

### 9.1 General provisions and scope

82. Article 37-5 of the LFS and articles 51 to 54 of the Grand-ducal MiFID regulation lay down in detail the reasonable steps investment firms must take to obtain the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
83. The best execution obligation is an obligation of means, not of result.
84. The institution does not have to obtain the best possible result for each individual order. However, the institution must be in a position to prove its clients, upon their request, that the orders have been executed in compliance with its execution policy which must aim at obtaining on a consistent basis the best possible result for the client.

### Institutions concerned

85. The best execution principle applies, in slightly different ways, to institutions executing client orders (article 37-5 of the LFS), as well as to institutions that only receive and transmit orders (article 53 of the Grand-ducal MiFID regulation). The requirements imposed on the latter are described in section 9.5.
86. An institution executes an order where it is the last element in the intermediary chain linking the order of the client to the execution venue (regulated market, MTF, systematic internaliser, market maker or another liquidity provider).
87. Management companies offering portfolio management services on a discretionary client-by-client basis are in principle exempted from the application of article 37-5 of the LFS, but must however apply the provisions of article 53 of the Grand-ducal MiFID regulation. Where they execute the orders themselves, they are required to comply with the provisions of article 37-5.

### Categories of clients concerned

- 88. Institutions must offer best execution to their retail clients as well as to their professional clients.
- 89. Best execution requirements do not apply to the provision of investment services to eligible counterparties. Nevertheless, the latter are entitled to require to be treated as professional or as retail client, either generally or for a specific transaction.

### Instruments and markets concerned

- 90. Best execution applies to all financial instruments listed in Annexe II, Section B of the LFS. Nevertheless, considering that financial instruments substantially differ in terms of standardisation, liquidity or number of execution venues, the implementation of best execution requirements shall be adapted to the characteristics of the relevant financial instrument. Indeed, best execution requirements are probably easier to apply to orders on shares traded on several liquid markets than to tailor-made transactions on structured products.

## 9.2 Specific instructions

- 91. Article 37-5(1) of the LFS specifies that where the client issues a specific instruction to an institution, the latter shall execute the order according to the specific instruction.
- 92. The institution meets its best execution obligation if it executes the order in accordance with this specific instruction. Where the instruction does not cover certain aspects of the operation, the institution is not released from the best execution obligation for these aspects.
- 93. In its execution policy, the institution shall warn the client that specific instructions are likely to prevent it to take the necessary measures to obtain the best possible result.
- 94. Moreover, an institution should not induce a client to issue specific instructions when the institution reasonably ought to know that such instructions are likely to prevent it from obtaining the best possible result for that client.

### 9.3 Execution policy

95. According to article 37-5(2) of the LFS, institutions shall set up and implement an execution policy that includes information on the execution venues used and the factors affecting the choice of the execution venue. Execution venue shall mean a regulated market, an MTF, a systematic internaliser, a market maker or other liquidity provider, or an entity that performs a similar function in a third country to the functions performed by any of the foregoing. In order to give effect to that policy, an institution should select the execution venues that enable it to obtain on a consistent basis the best possible result for the execution of client orders. Institutions are therefore not required to include in their policy all execution venues in relation to a type of or a specific financial instrument.
96. Institutions shall provide appropriate information to their clients on their execution policy and obtain prior consent from the clients to the execution policy. Information shall be provided on a durable medium or on a website. Prior consent of the client can be tacit provided that this has been agreed upon beforehand; for example, failing client objection after the time limit set down in the agreement and which follows the communication of information by the institution. The institution may also consider that the client gave his consent if the client sent an order after having received appropriate information on the execution policy.
97. Professional clients are supposed to be able to decide on their own which information they need. Where their information requests are reasonable and proportionate, institutions are required to provide this additional information.
98. Prior express consent of the client, either in the form of a general agreement or in respect of individual transactions must be obtained before executing orders outside a regulated market or an MTF. CESR specified that this express consent of the client is only required where the latter needs to make a choice. In case there is no alternative available, the institution can execute orders outside a regulated market or an MTF without obtaining the client's express consent.
99. Article 37-5(1) of the LFS lists the factors that institutions must consider in their choice between different execution venues. Where the institution executes an order on behalf of an individual client, total consideration, which is defined as the sum of the instrument's price and the costs related to execution, is considered to be the deciding factor.
100. As far as professional clients are concerned, even if total consideration is not automatically the prevailing criteria, it can be justifiably supposed to be relatively important compared to other criteria.
101. When selecting venues to be included in its execution policy, the institution shall not take into account the fees and commissions it charges the client.



At this stage, the institution should focus on the quality of execution available on the various venues.

102. However, when choosing a venue for the execution of a particular client order among the venues included in the execution policy, the institution should take into account the effect of its own fees and commissions on the total consideration to the client. Including these costs however does not oblige the institution to reconsider its price policy nor to compare its policy to its competitors, provided that fees and commissions charged are not structured such as to unfairly discriminate against different execution venues.
103. MiFID does not exclude the possibility to use only one execution venue for certain types of instruments or orders. Indeed, the access fees to multiple execution venues may turn out to be, in some cases, higher than the potential gains for the client. For orders on shares, the price quoted on the regulated market or MTF with the highest liquidity for the concerned share may in general be considered as offering the best total price. Similarly, for orders on UCI units/shares, the direct or indirect subscription, redemption or conversion of these units/shares at the net asset value within the central administration may in principle be considered as being in line with best execution criteria.
104. Where the institution decides to select only one execution venue, it shall nevertheless assess on a regular basis that the chosen execution venue actually provides on a consistent basis for the best possible result for the client.

#### 9.4 Review and monitoring

105. According to article 37-5(4) of the LFS, institutions are required to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies.
106. The institution shall, on the one hand, supervise that it executes orders in accordance with its execution policy, and, in particular, that the choice between execution venues has been made according to criteria laid down in its execution policy, and, on the other hand, assess whether the execution venues provided in its execution policy actually allow to obtain the best possible result for clients or whether other execution venues would provide better results.
107. At the request of its clients, the institution must be in a position to prove its clients that it executed their orders in accordance with its execution policy.

#### 9.5 Application to institutions performing portfolio management or reception and transmission of orders

108. Institutions that do not execute client orders themselves are not subject to the same requirements as those that execute orders. They shall however comply with the obligation to act in the best interest of their clients. In order to comply with this requirement, the institutions shall make sure that the entity executing the orders applies the provisions of article 37-5 of the LFS or equivalent provisions.
109. Article 53 of the Grand-ducal MiFID regulation specifies the requirements governing these institutions. In particular, they shall set up and implement a policy governing the selection of entities for execution. This policy is however not subject to client approval, nor does the institution need to demonstrate to the client that it observes this policy, but it needs to provide him with appropriate information thereon. It shall also control on a regular basis the quality of execution of the selected entities and review annually its policy more generally, as well as whenever a material change occurs, such as the introduction of a new potential execution venue.
110. An institution may decide to select only one entity to which it transmits all its orders, such as its parent company or an entity of the same group, if this choice allows to obtain on a consistent basis the best possible result for the client, which is to be verified by the institution on a regular basis.

## **Chapter 10 Client order handling rules**

### References:

LFS: Art. 37-6

Grand-ducal MiFID regulation: Art. 55 to 58

### 10.1 General comments

111. Institutions are required to implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or trading for own account.
112. These procedures shall follow the principle to act honestly and fairly in conducting investment activities in the best interest of the clients and the integrity of the market.
113. Article 56 of the Grand-ducal MiFID regulation imposes three conditions that institutions must satisfy when carrying out client orders:
  - (a) orders executed on behalf of clients are promptly and accurately recorded and allocated;
  - (b) client orders shall be carried out sequentially and promptly unless the characteristics of the order or prevailing market conditions

make this impracticable, or the interests of the client require otherwise;

- (c) retail clients must be informed about any material difficulty relevant to the proper carrying out of orders promptly upon becoming aware of the difficulty.

- 114. Where prevailing market conditions prevent the timely execution of a client limit order in respect of shares admitted to trading on a regulated market, and unless the client expressly instructs otherwise, the institution shall take own measures to facilitate the earliest possible execution of that order by making that client limit order immediately public in a manner which is easily accessible to other market participants.

## 10.2 Aggregation of orders and of transactions on own account

- 115. Aggregation of orders of different clients or of client orders with transactions on own account is in principle prohibited. The Grand-ducal MiFID regulation allows this provided the following conditions are met: the aggregation shall not work to the disadvantage of the client, the client shall be informed about any detrimental effect of the aggregation and the institution shall have an order allocation policy.
- 116. When aggregating transactions on own account with client orders, institutions shall not allocate the corresponding operations in a manner that is prejudicial to the client.

## **Chapter 11 Information to clients and potential clients**

### References:

LFS: Art. 37-3(2) and (3)

Grand-ducal MiFID regulation: Art. 31, 32, 34 to 39

### 11.1 General comments

117. Circular CSSF 2000/15 had laid down the requirement to communicate in an appropriate manner the relevant information when dealing with clients, so as to allow clients to take informed investment decisions. Information requirements of institutions towards their clients have been considerably strengthened by the MiFID law.
118. Thus, all information, including marketing communications, addressed by the institution to clients or potential clients shall be fair, clear and not misleading. An information should be considered to be misleading if it has a tendency to mislead the person or persons to whom it is addressed or by whom it is likely to be received, whether or not the person who provides the information considers or intends it to be misleading.
119. The Grand-ducal MiFID regulation sets down a detailed list of information that institution must communicate to their clients. In accordance with article 34(4) of the Grand-ducal MiFID regulation, institutions must provide the information concerned on a durable medium or, subject to certain conditions referred to in article 3(2) of that regulation, on a website. Pursuant to article 34(2) and (3), and except for the cases referred to in article 34(5), institutions must provide the information concerned in good time before providing investment services or ancillary services.
120. In order to allow clients to take informed investment decisions, they are provided with information of a general nature on the institution and its services (art. 34 and 35 of the Grand-ducal MiFID regulation), financial instruments and proposed investment strategies, including appropriate guidance on and warnings of the risks (art. 36 of the Grand-ducal MiFID regulation), execution venues (art. 37-3(3) of the LFS), arrangements made to protect the financial instruments and the clients' funds (art. 37 of the Grand-ducal MiFID regulation) and, finally, costs and charges associated with the financial instrument or investment service (art. 38 of the Grand-ducal MiFID regulation).
121. The full prospectus as regards units/shares of undertakings for collective investment subject to Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), the prospectus of Part II undertakings for collective investment

subject to the law of 20 December 2002, as well as the prospectus of specialised investment funds introduced by the law of 13 February 2007, and the prospectus of investment companies in risk capital in accordance with the provisions of the law of 15 June 2004 are deemed to provide the relevant information within the meaning of article 37-3 of the LFS. The prospectus concerned provide in particular sufficient information as regards financial instruments and proposed investment strategies, which should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies, as well as the costs and associated charges. The same applies to the simplified prospectus (art. 39 of the Grand-ducal MiFID regulation). Indeed, the MiFID law does not purpose to regulate the content of the simplified prospectus as defined in article 28 of Directive 85/611/EEC. Nevertheless, institutions that distribute UCITS units/shares shall in addition inform their clients of any other costs and charges associated with their provisions of investment services in relation to UCITS units/shares.

122. Appropriate and proportionate information requirements which take into account the status of a client as either retail or professional should be established. The MiFID law aims to ensure a proportionate balance between investor protection and disclosure obligations which apply to institutions. To this end, it is appropriate that specific information requirements that apply to professional clients are less stringent than for retail clients.

## 11.2 Retail clients

123. Any information addressed by institutions to or disseminated in such a way that it is likely to be received by retail clients or potential retail clients shall satisfy certain conditions listed in article 32 of the Grand-ducal MiFID regulation in order to be fair, clear and not misleading. This article also lists special requirements for comparative information, those that contain an indication on past and future performances, those that include or refer to simulated past performances as well as for those that refer to a particular tax treatment.
124. This information shall not refer to the CSSF in such a way that would indicate endorsement or approval by the CSSF of the products or services of the institution without prejudice to article 3 of the law on distance contracts for financial services.
125. The CSSF does not require prior approval of the content or the form of these marketing communications.
126. Institutions shall, in good time before a retail client or potential retail client is bound by any agreement for the provision of investment services or ancillary services or before the provision of those services, whichever is the earlier, provide that client or potential client with the relevant information. Exemptions from this requirement are provided, subject to certain

conditions specified by the Grand-ducal MiFID regulation, in the case of agreements concluded using means of distance communication or voice telephony communication (art. 34(5) of the Grand-ducal MiFID regulation).

127. Retail clients shall have sufficient time as from the reception of the information before taking their investment decision. A client is likely to require less time to review information about a simple or standardised product or service, or a product or service of a kind he has purchased previously, than he would require for a more complex or unfamiliar product or service.
128. Institutions providing portfolio management services are required to provide to retail clients or potential retail clients information on the types of financial instruments that may be included in the client portfolio and the types of transactions that may be carried out in such instruments. Such information should state separately whether the institution will be mandated to invest in financial instruments not admitted to trading on a regulated market, in derivatives, or in illiquid or highly volatile instruments; or to undertake short sales, purchases with borrowed funds, securities financing transactions, or any transactions involving margin payments, deposit of collateral or foreign exchange risk. Such separate information need not be provided where the institution invests in units/shares of UCITS that pursue investment policies that have the characteristics referred to by the information concerned. Units/shares of UCITS shall be considered as non-complex products in this respect. The same applies to units/shares of Part II UCIs provided that such UCIs pursue investment policies that would, where applicable, be accepted as being compliant with the UCITS regime.
129. The information which an institution is required to give to a retail client concerning costs and associated charges includes information either about the arrangements for payment or about the fulfilment of the agreement for the provision of investment services and any other agreement relating to a financial instrument that is being offered. For this purpose, payment arrangements will generally be relevant where a financial instrument contract is terminated by cash settlement. The terms of fulfilment will generally be relevant where, upon termination, a contract on a financial instrument requires the delivery of shares, bonds, a warrant, bullion or another instrument or commodity.

### 11.3 Professional clients

130. Professional clients should be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the institution to provide that information. Where their information requests are reasonable and proportionate, institutions are required to provide this additional information. Nevertheless, institutions should inform them in good time of cases where accounts that contain financial instruments or funds belonging to the clients are or will be subject to the

law of a third country (art. 37(6) of the Grand-ducal MiFID regulation) and, where applicable, of any security or lien which the institutions have or may have or any right of set-off (art. 37(7) of the Grand-ducal MiFID regulation) they hold in relation to the financial instruments or funds of professional clients.

## **Chapter 12 Need for a written agreement on rights and obligations of the parties**

### References:

LFS: Art. 37-3(7)

Grand-ducal MiFID regulation: Art. 45

131. Under the terms of article 37-3(7) of the LFS, institutions that provide investment services to clients shall lay down in writing the terms on which they provide services and the rights and obligations of the parties. The latter may be incorporated by reference to other documents or legal texts. A framework contract or the general terms between the institution and the client may, where applicable, fulfil this requirement.
132. As far as existing clients are concerned, provided appropriate documentation is available, this requirement is presumed to be fulfilled. As regards new clients, institutions shall draw up a basic agreement or general terms, on paper or another durable medium, setting out the essential rights and obligations of the institution and the client.

## **Chapter 13 Reports to provide to clients**

### References:

LFS: Art. 37-3(8)

Grand-ducal MiFID regulation: Art. 46 to 50

133. The MiFID law provides that reports relating to the execution of orders not related to portfolio management (art. 47 of the Grand-ducal MiFID regulation), reports concerning portfolio management (art. 48 of the Grand-ducal MiFID regulation), as well as statements of client financial instruments or client funds (art. 50 of the Grand-ducal MiFID regulation) shall be addressed to clients on a regular basis. The detailed rules on information to provide to clients and the periodicity of the reports to address to clients vary in accordance with the nature of the investment service provided and with the category of client, retail or professional.
134. Where a proxy was validly appointed and acts as intermediary between the client and the institution, the reports concerned shall be addressed to the appointed proxy and to the client, except where otherwise instructed by the client.
135. Where institutions provide portfolio management transactions for retail clients or operate retail client accounts that include an uncovered open position in a contingent liability transaction, they shall report to the retail client any losses exceeding a predetermined threshold, agreed between the institution and the client, no later than the end of the business day in which the threshold is exceeded or, in a case where the threshold is exceeded on a non-business day, the close of the next business day (article 49 of the Grand-ducal MiFID regulation). This requirement is only valid where institutions have agreed on such a predetermined threshold with the client.
136. Where the institution agreed with the client on a benchmark in a discretionary management agreement, the institution shall include in the periodic statements a performance comparison during the period covered by the statement with the benchmark agreed upon with the client.



## **Chapter 14 Record keeping**

References:

LFS: Art. 37-1(6)

Grand-ducal MiFID regulation: Art. 60 and 61

137. Article 61(3) of the Grand-ducal MiFID regulation requires the CSSF to draw up and maintain a list of minimum records institutions are required to keep. It takes account, among other things, of the terms of article 37-1(6) of the LFS which requires that institutions keep records of any service they have provided and of any transaction they have made in order to allow the CSSF to monitor whether they comply with their obligations under MiFID, and in particular their obligations towards the clients.
138. CESR has drawn up a harmonised list of minimum records, which is appended to this circular (Annexe III). The CSSF considers this list as sufficient to allow, among other things, institutions to comply with the record keeping obligations referred to in article 37-1(6) of the LFS.

## **Chapter 15 Rules governing specific competitive situations**

139. The “rules governing specific competitive situations” as set out below and detailed in Part V of circular CSSF 2000/15 are renewed by points 140 to 142.
140. The institution shall refrain from luring away or attempting to lure away clients from a competitor using unfair means. It shall not seek to obtain and use confidential information on the clients of a competitor and at the disposal of a member of its staff previously employed by this competitor. It shall also make sure that its staff does not actively use this information for the same purpose.
141. The institution shall refrain from any such practice, notably if an account manager changes the employer, in which case and depending on the circumstances, the institution and the employee concerned might be held responsible in many aspects under criminal and civil law.
142. The CSSF might challenge the professional reputation of persons referred to in Articles 7 and 19 of the LFS in case it becomes aware of such behaviour.

## **Chapter 16 Repealing provisions and entry into force**

143. This circular enters into force on 1 November 2007. Circular CSSF 2000/15 is repealed with effect of 1 November 2007.

Yours faithfully,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

Simone DELCOURT  
Director

Arthur PHILIPPE  
Director

Jean-Nicolas SCHAUS  
Director General

### **Annexes:**

- Annexe I: CESR's Recommendations on Inducements under MiFID  
Annexe II: CESR's Questions and Answers Paper on Best Execution under MiFID  
Annexe III: CESR's Level 3 Recommendations on the List of minimum records in article 51(3) of the MiFID implementing Directive  
Annexe IV: ESMA's Guidelines on certain aspects of the MiFID suitability requirements<sup>2</sup>  
Annexe V: Guidelines on remuneration policies and practices (MiFID)<sup>3</sup>

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<sup>2</sup> Added by Circular CSSF 13/560

<sup>3</sup> Added by Circular CSSF 14/585, removed by Circular CSSF 23/841



THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-228b

## Inducements under MiFID

### Recommendations

**May 2007**



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Annex B(2): To show the treatment under Article 26 of a fee, commission or non-monetary benefit *paid by* a firm in connection with a service provided to its client



## 1. Introduction

Article 19(1) of the Level 1 Markets in Financial Instruments Directive 2004/39/EC ("MiFID") provides that when providing investment services and/or, where appropriate, ancillary services to clients an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients. Article 26 of the MiFID implementing Directive 2006/73/EC ("Level 2 Directive"), entitled "Inducements", sets further requirements in relation to the receipt or payment by an investment firm of a fee, commission or non-monetary benefit that could, in certain circumstances, place the firm in a situation where it would not be acting in compliance with the principle stated in MiFID Article 19(1).

In its consultation papers (CESR/06-687 published in December 2006 and CESR/07-228 published in April 2007) CESR explained that it was considering issuing a recommendation setting out a common supervisory approach to the operation of Article 26 of the Level 2 Directive.

### **Objective of the recommendations**

The public consultation has allowed CESR to understand and to take into account the views of market participants (both investment firms and consumers). Following consultation CESR is providing recommendations that are intended to facilitate a consistent implementation of Article 26 of the Level 2 Directive without imposing further obligations on investment firms. This will help investment firms to assess the way in which the provisions will be interpreted.

It is important to note that the main objective behind the inducements rules in MiFID is investor protection. In elaborating these Level 3 recommendations, CESR's intention has been to implement this principle by taking into account valid considerations such as level playing field between the treatment of financial instruments and business models that are within the scope of application of the inducements rules under MiFID.

The recommendations are, therefore, designed to foster supervisory convergence across the EU and to ensure consistent implementation and application of the Level 2 Directive.

### **Status of the recommendations**

The outcome of CESR's work is reflected in the recommendations set out in this paper which are addressed to CESR members, which are provided with explanatory text. These do not constitute European Union legislation and will not require national legislative action. CESR Members will apply the recommendations in their day-to-day supervisory practices on a voluntary basis. The recommendations below are not stand-alone obligations or new requirements.

The European Commission has participated as an observer in the course of CESR's elaboration of the recommendations. In particular, CESR has discussed with the Commission the interpretation of the legal obligations under MiFID and its Level 2 Directive on inducements; the Commission agrees with the legal interpretation given by CESR. Furthermore the Commission considers that the contents of this paper do not go beyond the MiFID legal texts and that the approach taken in this paper comes from the normal, natural reading of MiFID and the Level 2 Directive.

CESR recommendations for the consistent implementation of MiFID and of the Level 2 Directive will not prejudice, in any case, the role of the Commission as guardian of the Treaties.



### **General comments on responses to consultations**

In developing its recommendations CESR has carefully considered the responses to its two consultation papers from the industry and from consumer representatives. Many industry respondents suggested that CESR had been in error in determining the scope of Article 26 of the Level 2 Directive. In particular, they suggested that "standard commissions or fees"<sup>2</sup>, were outside the scope of Article 26 altogether or, if not, that they were outside the scope of Article 26(b). CESR has considered these comments very carefully as they are fundamental to a proper understanding of the provisions. However, CESR has concluded that the interpretation of Article 26 that it adopted in its consultation papers is correct. Article 26 must be interpreted in the context of Article 19(1) of MiFID; but, although Article 26 is entitled "inducements", its content covers any fee or commission or non-monetary benefit that an investment firm may receive or pay in connection with the provision of investment and ancillary services to clients. It sets the characteristics of these fees and commissions in order for a firm to act honestly, fairly and professionally in accordance with the best interests of its clients. So, "standard commissions and fees" (for example, those that are customary in and at the usual level in a particular market) are of a nature to fall within Article 26. CESR has discussed this with the Commission, which, in relation to this issue of scope, agrees with CESR.

It has been argued that the disclosure element in inducements could favour a system of vertical integration at the disadvantage of the so called 'open architecture'. CESR is clarifying in this document that intra-group inducements are covered by the application of the provisions of the MiFID Level 2 Directive. In this way, payments made between distinct legal entities pertaining to the same group which only offer their own products are treated in the very same way as payments in the context of 'open architecture' firms.

The recommendations provided by CESR do not discriminate between different types of financial instrument and apply to all financial instruments within MiFID scope (see Annex I, section C of MiFID). They apply only to firms within the scope of MiFID. So, for example, they do not apply to the managers of collective investment undertakings where they are acting within the scope of the exemption provided in Article 2(1)(h) of MiFID (unless Member States apply such requirements, in the exercise of discretion outside the scope of MiFID). Where potential regulatory arbitrage cannot be simply addressed and resolved by virtue of application of MiFID (eg for investment products that do not fall under the scope of MiFID), CESR will signal this potential arbitrage to the European Commission for possible European regulatory interventions.

CESR has also taken this opportunity to illustrate a greater degree of flexibility in the interpretation of "designed to enhance the quality of the service and not impair compliance with the firm's duty to act in the best interests" of its clients, in particular, in response to industry concerns about the application to standard commissions and fees.

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<sup>2</sup> The term "standard commission or fee" is used in Article 21(e) of the Level 2 Directive in the context of establishing minimum criteria for identifying types of conflict of interest that arise in the course of providing an investment or ancillary service. The term is not used in Article 26.

## 2.. Recommendations

### General

1. Article 19(1) of the Level 1 Directive requires investment firms to act honestly, fairly and professionally in accordance with the best interests of their clients when providing investment services and/or, where appropriate, ancillary services. Other provisions of MiFID and of its implementing provisions provide measures relevant to the same objective. The main provisions in this field include those set out in Articles 19(2) to 19(8) of the Level 1 Directive and Articles 26 to 45 of the Level 2 Directive.
2. Article 26 of the Level 2 Directive sets further requirements in respect of the general duty to act in accordance with the best interests of clients. It is intended, in particular, to set standards for the payment and receipt by investment firms of fees, commissions and non-monetary benefits. This is because such benefits, in some circumstances, place the firm in a situation where it would not be in compliance with the general duty to act in accordance with the best interests of clients. In order to do so, the Article applies in relation to the receipt or payment by an investment firm of any fee, commission or non-monetary benefit, but applies in a different way to different types. It does not deal with payments made within the investment firm, such as internal bonus programmes, even though these could give rise to a conflict of interest covered by Article 21<sup>3</sup> of the Level 2 Directive.
3. Inducements are referred to in Article 21 of the Level 2 Directive and in the title of Article 26 of the Level 2 Directive. Article 21 sets out minimum criteria that a firm must take into account in identifying relevant types of conflict of interest. Article 26 sets conditions that must be met in order for a fee, commission or non-monetary benefit to be allowed. In doing so, it applies to all fees, commissions and non-monetary benefits that are paid or provided to or by an investment firm in relation to the provision of an investment or ancillary service to a client. Therefore, Article 26 should not be treated as applying only to payments or receipts that are made with the purpose or intent to influence the actions of a firm. However, regulators and supervisors will, of course, direct their attention to items and situations in which there is a greater possibility of harm to the interests of clients.
4. Article 26 applies only to items received or provided by an investment firm, whereas through the concept of “relevant persons” the rules on conflicts of interest also apply to individuals working for the investment firm. When a relevant person is acting for the firm in relation to the provision of an investment or ancillary service to a client Article 26 also applies to items paid by a third party to that relevant person acting in such a capacity. Small gifts and minor hospitality below a level specified in a firm's conflicts of interest policy are irrelevant for this purpose.
5. The scope of application of Article 26 is the same in relation to payments between firms that are members of the same group as it is to payments between firms that are not members of the same group.

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<sup>3</sup> Articles 21 to 23 (Conflicts of interest) of the Level 2 Directive provide elaboration of the principles set out in Articles 13(3) and 18 of the Level 1 Directive.

Recommendation 1: General

CESR considers that:

(a) Article 26 of the MiFID Level 2 Directive applies to fees, commissions and non-monetary benefits paid by an investment firm or received by it in relation to the provision by it of an investment or ancillary service to a client. Such fees, commissions and non-monetary benefits include commissions or fees that may be paid or provided to or by an investment firm and which are standard in the market;

(b) The application of Article 26 is the same in relation to a payment or non-monetary benefit provided to or made by a legal entity within the same group as the investment firm as it is to one provided to or made by any other legal entity.

Article 26 (a) of the Level 2 Directive : items "provided to or by the client"

6. Article 26(a) provides for circumstances in which an investment firm is not prohibited from paying or receiving fees, commissions or non-monetary benefits in relation to an investment or ancillary service provided to a client. The circumstances are where the item is a "*fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client*".
7. In CESR's view it is clear that if the client himself negotiates and pays a fee for a service provided by the investment firm then the payment of that fee will be within Article 26(a). Another clear circumstance will be if someone is acting under a general power of attorney on behalf of the client. The effect in such cases of Article 26(a) is that the relevant payments will not be subject to Article 26(b). This will not affect the operation of disclosure under Article 19(3) of MiFID and its implementing provisions.
8. To consider a payment made or received on behalf of the client under Article 26(a), the client needs to be aware that this payment has actually been made or received on his behalf. The client may of course give a specific separate instruction to a person to act on his behalf in making or receiving the payment of a fee or commission. This would generally include circumstances in which there is a clear payment instruction, agency agreement, or the other person is acting as a "mere conduit" for the payment.

Recommendation 2: Article 26(a)

CESR considers that:

Article 26(a) applies when the payment is made/received by the client or by a person on behalf of the client. This includes where the client pays a firm's invoice directly or it is paid by an independent third party who has no relevant connection with the investment firm regarding the investment service provided to the client, such as an accountant or lawyer, acting on behalf of the client. A separate, specific instruction issued by the client to the investment firm to receive or make a payment on his/her behalf will also be relevant. The fact that the economic cost of a fee,



commission or non-monetary benefit is borne by the client is not alone sufficient for it to be considered within Article 26(a).

#### Article 26 (c) of the Level 2 Directive

9. Article 26(c) defines a category of item ("proper fees") that can be paid to or provided by an investment firm. It contains two tests that the payment must meet in order for the exception to apply. The first one is that the payment must "enable or be necessary" for the provision of the service; the second one is that "by its nature [it] cannot give rise to conflicts with the firm's duty to act honestly, fairly and professionally in accordance with the best interests of the client." Any items that are of a type similar to the proper fees it mentions, that is custody costs, settlement and exchange fees, regulatory levies or legal fees which "enable or are necessary for the provision of investment services" and "which, by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients" will not be subject to Article 26(b). This will not affect the operation of disclosure under Article 19(3) of MiFID and its implementing provisions..
10. The list of items provided by Article 26(c) cannot be exhaustive. Within Article 26(c) are a number of conditions or factors that must be considered in determining whether an item can be considered to fall within it. Particularly important is whether an item by its nature cannot give rise to conflicts with the firm's duty to act, honestly, fairly and professionally in accordance with the best interests of its clients. This is a test that needs to be considered in the abstract, on the "nature" of the item; that is not on the basis of whether the result of the payment has been to give rise to such a conflict. The possibility of a receipt of a standard commission or fee is of a nature to give rise to conflicts with the duty owed to clients. (For example, it can provide an incentive to act in other than the best interests of the client because it is to the firm's advantage to make recommendations that will maximise the commission the firm will earn).

#### BOX 3

##### Recommendation 3: Article 26 (c) of the Level 2 Directive

CESR considers that:

The list of items mentioned within Article 26(c) of the Level 2 directive is not exhaustive, but in considering whether items that are not specifically mentioned also fall within Article 26(c) the factors that are mentioned within it need to be considered. Of particular importance is whether an item by its nature cannot give rise to conflicts with the firm's duty to act, honestly, fairly and professionally in accordance with the best interests of its clients.

#### Article 26(b): conditions on third party receipts and payments

11. In CESR's view, Article 26 (b) performs two functions:
  - First, it ensures disclosure of legitimate third party payments and non-monetary benefits that do meet the tests established in Article 26 (b) (ii).
  - Second, the article prohibits certain third party payments and non-monetary benefits. That is, those that do not meet the tests set out in Article 26 (b) (ii).



12. Items that are not "proper fees which enable or are necessary for the provision of investment services (...) and by their nature cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its client" and that are paid to the investment firm by a third party (or which the investment firm pays to a third party) and not the client or a person on behalf of the client, are dealt with under Article 26 (b) of the Level 2 Directive.
13. Unlike payments to and receipts from clients these have to meet a number of conditions in order not to be prohibited. These are:
  - (a) the item must be designed to enhance the quality of the relevant service to the client and it must not impair compliance with the firm's duty to act in the best interests of the client; and,
  - (b) there must be clear, prior disclosure to the firm's client.
14. These tests appear to be primarily concerned with circumstances in which the client of an investment firm will bear the cost of the payment or receipt of a monetary or non-monetary benefit to or by an investment firm, but which may also result in some benefit to the investment firm. In these circumstances the interests of the investment firm and its client are not necessarily the same or aligned. Article 26(b) puts regulatory controls around payments where there is the possibility of client detriment.
15. Ordinarily, the two legs of the test in (a) in par. 13 would be considered as a whole, but it is worth noting that in relation to "designed to enhance the quality of the relevant service to the client", the use of the word designed makes clear that a judgement about a fee or payment, or arrangements for fees or payments, can be made at the time the arrangement is proposed, rather than only once a payment has been made. Further, CESR considers that such payments may also benefit other clients or groups of clients apart from the particular client that is receiving the investment service; in this case the requirement to enhance the quality of the relevant service to the client is met at the level of the service, provided that the other clients or groups of clients are receiving such a service. For example, a bank will be able to assess the requirement at the level of reception and transmission of orders placed by all its clients and relating to a specific business line towards these clients. However, it will not be able to assess this requirement at the level of the service provided to all its clients over different business lines. The assessment at the level of service should not be interpreted too widely to convert the test into a meaningless exercise. This does not prevent competent authorities from assessing compliance with the requirements on the basis of the effective use that is made of inducements received by a given firm.
16. CESR considers it will be helpful to CESR members to set out factors that could be used in determining whether arrangements that an investment firm has entered into or proposes to do so are consistent with the test in (a) in par. 13 above. Factor (d) will be particularly relevant in some cases, for example, if the investment firm and the third party have a number of joint or common interests. In these cases, firms should assess whether these relations are influencing the firm to act in a way that is not in the best interests of the client. It is important to note that the factor in recommendation 4(d) will not always be relevant; the fact that a group relationship exists is not by itself relevant.
17. On factor (c), conflicts management measures can help to mitigate the effect of incentives that could influence the investment firm to act other than in the best interests of the client. It is important to stress that the conflicts management rules and the inducements rules are complementary and not substitutes or alternatives. Compliance with the conflicts rules does not provide a safe-harbour from the inducements rules. Compliance with the inducements rules does not provide a safe-harbour from the conflicts rules.



18. The factors included in Recommendation 4 must be considered as tools to help investment firms and CESR members to assess whether current and future arrangements investment firms are considering entering into are consistent with Article 26. The factors do not represent a 'one size-fits all approach' and are not intended to apply uniformly to all situations.
19. The factors set out in Recommendation 4 are relevant to both advice-based and non advice-based distribution models, and in general for the provision of all investment and ancillary services. They are indicative criteria only and not strict or exhaustive factors that must be taken into account in all cases. They are not standalone obligations or new requirements.

#### BOX 4

##### **Recommendation 4: Factors relevant to arrangements within Article 26(b)**

**CESR considers that the following are among the factors that should be considered in determining whether an arrangement may be deemed to be designed to enhance the quality of the service provided to the client and not impair the duty of the firm to act in the best interests of the client:**

- (a) The type of the investment or ancillary service provided by the investment firm to the client, and any specific duties it owes to the client in addition to those under Article 26, including those under a client agreement, if any;**
- (b) The expected benefit to the client(s) including the nature and extent of that benefit, and any expected benefit to the investment firm; the analysis about the expected benefit, can be performed at the level of the service to the relevant client or clients;**
- (c) Whether there will be an incentive for the investment firm to act other than in the best interests of the client and whether the incentive is likely to change the investment firm's behaviour;**
- (d) The relationship between the investment firm and the entity which is receiving or providing the benefit (although the mere fact that a group relationship exists is not by itself a relevant consideration);**
- (e) The nature of the item, the circumstances in which it is paid or provided and whether any conditions attach to it.**

##### **Recital 39 of the Level 2 Directive**

20. In relation to the nature of the investment service, is important to take into account Recital 39 of the Level 2 Directive. This refers to situations where investment firms are paid by commissions received from product providers (such as, by the management company of a collective investment scheme). CESR's view is that recital 39 makes clear that such a type of remuneration can be legitimate, provided that the investment firm's advice or general recommendation to its client is not biased as a result of the receipt of that commission. If this condition is met then the advice or recommendation should be considered as having met the condition of being designed to enhance the quality of the service to the client. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interest of the client – must also, of course, be met, as must other obligations under MiFID.

21. Recital 39 is limited to an investment firm that is giving unbiased investment advice or general recommendations. However, it does not exclude that other cases may be treated in similar terms. An example is where an issuer or product provider pays an investment firm for distribution where no advice or general recommendation is provided. In such cases the investment firm will be providing an investment service to its end-clients; in the absence of payment by the product provider or issuer these investment services, most likely, would not be provided; therefore, in the distribution of financial instruments the payments could be seen as being designed to enhance the quality of the service to the client by allowing that investment service being performed over a wider range of financial instruments. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interest of the client – must also, of course, be met, as must other obligations under MiFID.

#### BOX 5

##### Recommendation 5: Recital 39 to the Level 2 Directive

CESR considers that:

- (a) Recital 39 makes clear that where an investment firm provides investment advice or general recommendations which are not biased as a result of the receipt of commission then the advice or recommendations should be considered as having met the condition of being designed to enhance the quality of the service to the client. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty to act in the best interests of the client – must be met;
- (b) Recital 39 is relevant to cases in which an investment firm is giving unbiased investment advice or general recommendations. It is not exhaustive and does not prohibit other distribution arrangements under which an investment firm receives a commission (from, for example, a product provider or issuer) without giving investment advice or general recommendations. For these cases, payments can be seen as being designed to enhance the quality of the service to the client by allowing a given investment service to be performed over a wider range of financial instruments. The other conditions of Article 26 (b) – disclosure, and, the obligation not to impair compliance with the duty act in the best interests of the client – must be met.

##### Article 26(b) of the Level 2 Directive: Disclosure

22. Article 26 recognises in 26 (b) clear, prior disclosure to the firm's client as one of the conditions for receipts or payments paid or provided to or by a third party to be permitted.
23. As far as the content of the disclosure is concerned, Article 26 (b) (I) is clear in setting out the information that an investment firm should provide, that is: *“the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount”*. A generic disclosure which refers merely to the fact that the firm may or will receive inducements is not in CESR's view sufficient to enable the investor to make an informed decision and therefore will not be considered as meeting the requirements of Article 26.
24. The final paragraph of Article 26, however, allows the investment firm to provide a "summary disclosure" (*“the essential terms of the arrangements relating to the fee,*



*commission or non-monetary benefit in summary form*") rather than the full information. CESR considers that means it must contain enough information to enable the client to make an informed decision.

25. There has been some concern about distribution channels where between a product provider and the final client there is at least one further intermediary. Each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients in relation to the services that it provides.

**BOX 6**

**Recommendation 6: Disclosure under Article 26(b) of the Level 2 Directive**

**CESR considers that:**

(a) in order to contain the "essential terms" a summary disclosure must provide adequate information to enable the investor to relate the disclosure to the particular investment or ancillary service that is provided to him, or, to the products to which it relates, to make an informed decision whether to proceed with the investment or ancillary service and, whether to ask for the full information;

(b) a generic disclosure which explains merely that the firm will or may receive or pay or provide items within Article 26(b) is not sufficient to enable a client to make an informed decision and therefore will not be considered as providing the "essential terms of the arrangements" referred to in Article 26 of the Level 2 Directive;

(c) when a number of entities are involved in the distribution channel, each investment firm that is providing an investment or ancillary service must comply with its obligation of disclosure to its clients.

### 3. Illustrative examples to show the application of the Recommendations

26. In order to explain how Article 26 operates CESR provides below a number of examples. These illustrate some of the variety of circumstances in which Article 26 of the Level 2 Directive is relevant.
27. The examples deal only with the application of Article 26 of MiFID Level 2 Directive in relation to the circumstances they mention and are presented without prejudice to firms' other obligations under MiFID.
28. The examples are for illustration purposes only; although they are intended to be helpful in assessing cases that arise in practice, each such case must be assessed on its own merits and in accordance with its own circumstances. It is not correct to extrapolate the conclusions reached in these examples without a thorough analysis of the context and specific circumstances of each case.

- I. *A client of an investment firm agrees a fee of €100 an hour plus disbursements for the service of investment advice. The investment firm provides the advice and issues an invoice for 10 hours work €1000 and an additional €200 for disbursements. The client pays the invoice himself or instructs his accountant to pay the invoice.*

The payment is clearly paid by the client or by a person on behalf of the client and as such is within Article 26(a) of the Level 2 Directive. No additional requirements under Article 26 apply to the arrangements.

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- II. *A client of an investment firm that provides portfolio management services agrees a fee of 1% per annum of assets under management charged pro rata to be paid out of assets under management and that dealing costs such as dealing fees charged by brokers will also be paid out of the client's assets.*

The payments out of the client's funds for the service of portfolio management are clearly paid by the client or by a person on behalf of the client and as such are within Article 26(a) of the Level 2 Directive. The payment of the dealing fees will amount to payments on behalf of the client within Article 26(a). No additional requirements under Article 26 apply to the arrangements.

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- III. *A client has agreed with investment firm (A) the fee that he will pay to (A). The client could, if he wishes in connection with an investment or ancillary service provided by (A), also provide an explicit instruction to (C) to pay the amounts that the client owes to investment firm (A) out of the client's account with (C). The client is able to instruct (C) to cease to make such payments.*

Here it is clear that (C) is acting on behalf of its client and the arrangements are within Article 26 (a), and, that (C) is not a "third party" such as to require the tests of Article 26(b) to be met.

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- IV. A client of an investment firm that provides portfolio management services agrees a fee of 1% per annum of assets under management charged pro rata to be paid out of assets under management and that dealing costs such as dealing fees charged by brokers will also be paid out of the client's assets. The portfolio manager agrees with one broker that 20% of the dealing fees above a certain level each year will be repaid. These are paid to the portfolio manager.*

The payments to the investment firm out of the client's assets for the service of portfolio management are clearly paid by the client or by a person on behalf of the client and as such are within Article 26(a) of MiFID Level 2. In this case the portfolio manager has also negotiated a further payment to itself. This receipt by the investment firm from a "third party" (the broker) falls within Article 26(b) and in order for the portfolio manager to retain it and not pay it to the client the tests within Article 26(b) would have to be met. Particularly relevant could be factors 4 (a), (b) and 4(c). The arrangement entered into by the investment firm does not appear to provide any new benefit for the clients of the investment firm. The investment firm itself receives a benefit and therefore has an incentive to use only the broker offering the payments. Any enhancement of the service provided to the investment firm's clients seems unlikely, but the incentive is likely to impair the firm's duty to act in the best interest of its clients (for example, to provide best execution).

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- V. An investment firm provides a portfolio management service to a client and charges a fee for that service. The investment firm purchases financial instruments for its client; the provider of those financial instruments pays a commission to the investment firm that is paid out of the product charges made to the client.*

CESR's view is that such arrangements are not altogether prohibited. The receipt of commission in addition to the management fees received for the service of portfolio management is clearly of a nature that could impair the firm's duty to act in the best interests of its client. One clear option for the investment firm is to repay to its client any commissions received. If the investment firm wishes not to do so then special attention has to be paid, since it would be difficult for portfolio managers to meet the other conditions within Article 26, especially the duty to act in the best interests of the client.

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- VI. A client (C) of an investment firm (F) wishes to deal in instruments that (F) does not offer. Therefore (F) introduces (C) to another investment firm (A). (C) becomes a client of investment firm (A). (A) provides investment services to (C) and charges transaction fees to (C). (A) then pays a share of those fees to the introducing investment firm (F).*

The arrangements need to be considered from the perspective of both the paying investment firm (A) and the receiving investment firm (F).

CESR's view is that the payment by the investment firm (A) will fall within Article 26(b), and can be considered to be designed to enhance the quality of the service to the client. The payment to the introducing broker must be disclosed and not impair the investment firm's duty to act in the best interest of the client.

CESR's view is that the receipt by the investment firm, where received in connection with an investment or ancillary service provided to (C), will fall within Article 26(b). (F) will need to consider carefully whether the arrangements are permitted under Article 26(b) and for this purpose may find the factors set out in Recommendation 4 useful. Article 26(b) also requires the receipt of the benefit to be disclosed.

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- VII. An investment firm provides investment advice or general recommendations to its client, transmits orders to product providers on behalf of the client and it does not charge a fee to its clients but receives commission from the product providers when it arranges such sales.*

If the *investment* advice or general recommendation is not biased as a result of the receipt of commissions the receipt should be considered as designed to enhance the quality of the investment advice to the client. The other conditions of Article 26 (b) will also have to be met, and Recommendation 4 (c) will be particularly relevant.

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- VIII. As Example VII above, except that the investment firm receives an additional one-off bonus (or "override") payment once sales of a particular product reach an agreed level.*

Factors 4(b), (c) and (e) are particularly relevant to such an arrangement, and it is doubtful that Article 26(b) can be satisfied. As sales approach the target level it becomes more likely that the firm's advice will become biased towards that particular product, in breach of the duty to act honestly, fairly and professionally in accordance with the best interests of the client.

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- IX. An investment firm that is not providing investment advice or general recommendations has a distribution or placing agreement with a product provider or issuer to distribute its products in return for commission paid for by the product provider or a member of its group.*

In such a case the investment firm will be providing an investment service to its end-clients; in the absence of payment by the product provider or issuer these investment services, most likely, would not be provided; therefore, the payments may be seen as being designed to enhance the quality of the service to the client. The other elements of Article 26 (b) must also be met and in considering this, Recommendation 4(c) in particular may be relevant.

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- X. An investment firm is providing the ancillary service of corporate finance advice (falling within Section B (3) of Annex I of MiFID). In doing so it incurs its own costs such as fees for legal advice which it does not recharge to its client.*

These costs, *if* they are within Article 26 of the Level 2 Directive at all, are within Article 26(c).

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- XI. A product provider provides (without charge) training to the staff of an investment adviser that is an investment firm.*

Such training will be a non-monetary benefit provided to the investment firm and most likely within Article 26(b) of the Level 2 Directive. Within Recommendation 4, factors (b), (c) and (e) will be relevant, for example, the extent to which the training is in relation to services provided to the clients. Training that is provided in an exotic holiday location paid for by the provider is more likely to impair the investment firm's duty to act in the best interests of the client and so not be permitted.





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*XII. A broker provides to an investment firm general office equipment such as computer equipment.*

The office equipment will be a non-monetary benefit provided to the investment firm and most likely within Article 26(b) of the Level 2 Directive. Within Recommendation 4, factors (b), (c) *and* (e) will likely be relevant. Assessment of such items will vary on a case by case basis, depending on all the circumstances. Where equipment provided is closely related to services provided to clients then its provision to an investment firm is more likely to be permitted. Where it is "general" office equipment that can be used for a wide range of purposes within the firm then assessment against the factors in Recommendation 4 is more likely to lead to a conclusion that the item should not be permitted.

**Annex A: Extracts from MiFID Implementing Directive 2006/73/EC**

***Recitals 39 and 40***

- (39) For the purposes of the provisions of this Directive concerning inducements, the receipt by an investment firm of a commission in connection with investment advice or general recommendations, in circumstances where the advice or recommendations are not biased as a result of the receipt of commission, should be considered as designed to enhance the quality of the investment advice to the client.*
- (40) This Directive permits investment firms to give or receive certain inducements only subject to specific conditions, and provided they are disclosed to the client, or are given to or by the client or a person on behalf of the client.*

***Article 21:***

*Member States shall ensure, for the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, investment firms take into account, by way of minimum criteria, the question of whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise:*

*(...)*

*(e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies goods or services, other than the standard commission or fee for that service.*

***Article 26:***

*Member States shall ensure that investment firms are not regarded as acting honestly, fairly and professionally in accordance with the best interests of a client if, in relation to the provision of an investment or ancillary service to the client, they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit other than the following:*

*(a) a fee, commission or non-monetary benefit paid or provided to or by the client or a person on behalf of the client;*

*(b) a fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:*

- (i) the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service;*
- (ii) the payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the firm's duty to act in the best interests of the client.*

*c) proper fees which enable or are necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which,*

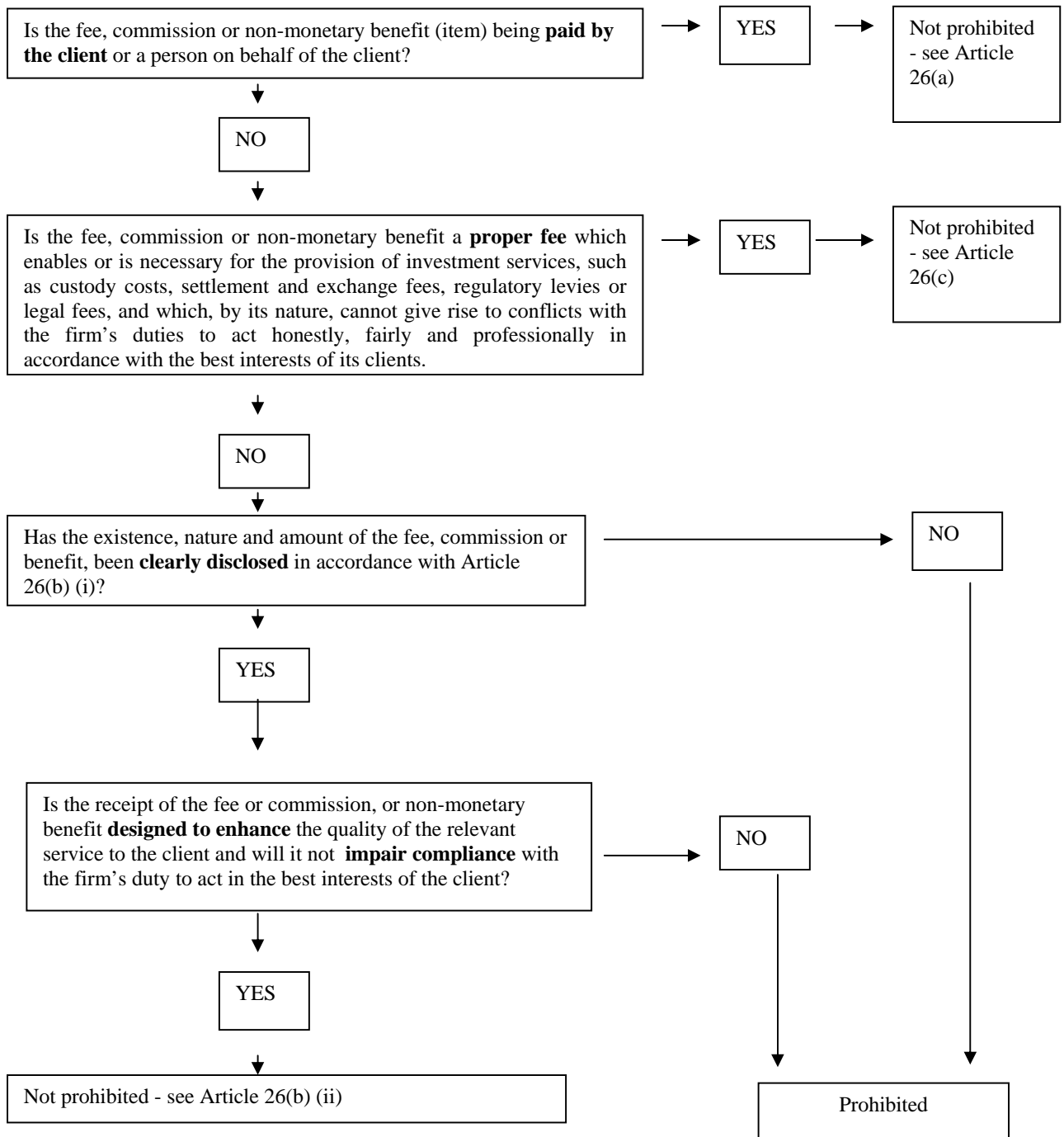


*by their nature, cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients.*

*Member States shall permit an investment firm, for the purposes of point (b)(i), to disclose the essential terms of the arrangements relating to the fee, commission or non-monetary benefit in summary form, provided that it undertakes to disclose further details at the request of the client and provided that it honours that undertaking”.*

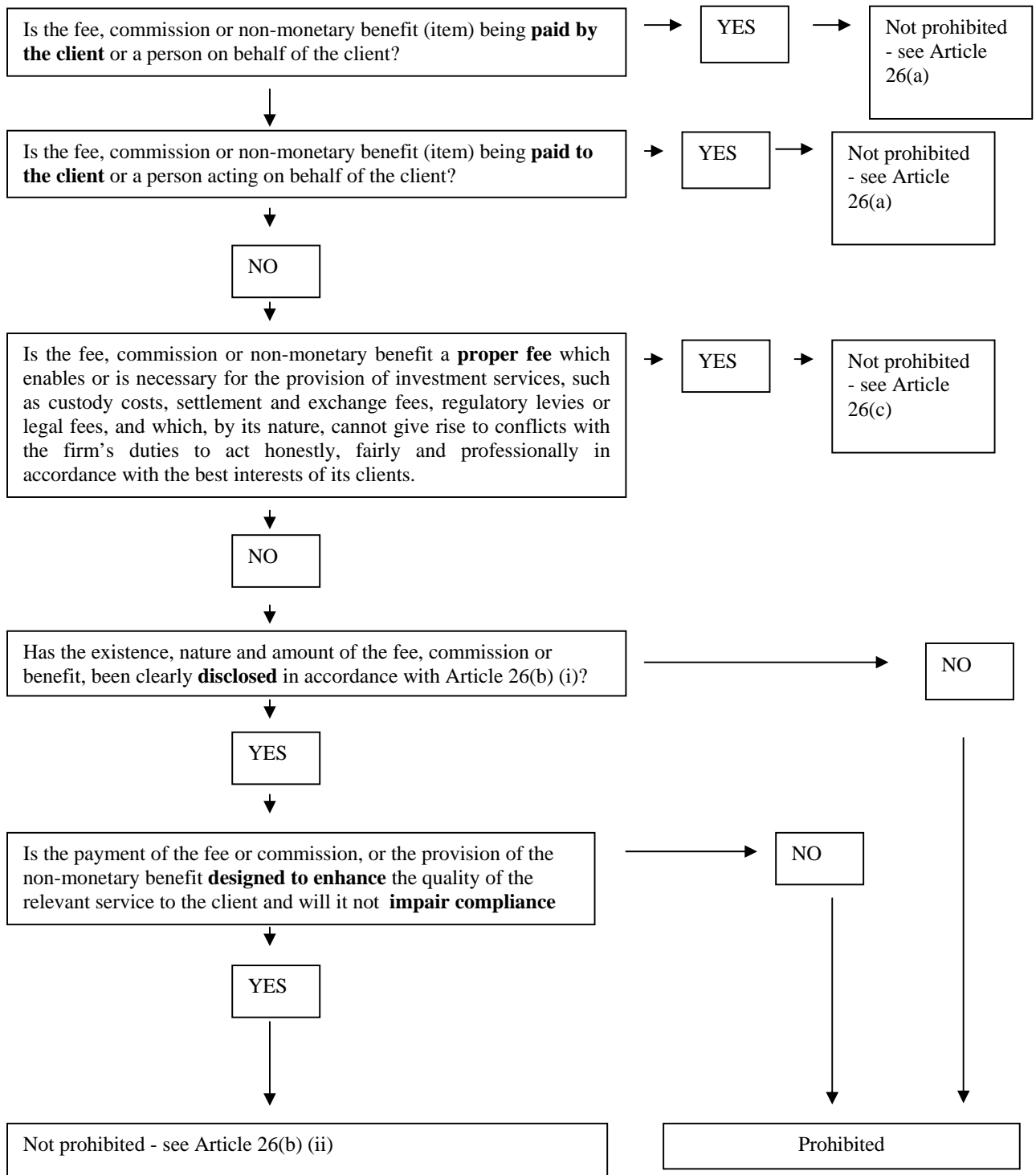
## Annex B (1)

To show the treatment under Article 26 of a fee, commission or non-monetary benefit *received by a firm in connection with a service provided to its client*



# Annex B (2)

To show the treatment under Article 26 of a fee, commission or non-monetary benefit *paid by a firm in connection with a service provided to its client*







THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-320

## Best Execution under MiFID

### Questions & Answers

**May 2007**



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## Section 1 – Background and Scope

### *Introduction*

MiFID will introduce common standards of investor protection throughout the European Union. MiFID's best execution requirements are an important component of these investor protection standards as they are designed to promote both market efficiency generally and the best possible execution results for investors individually.

Discussions in the CESR Implementation Forum suggested that many Member States and competent authorities will implement MiFID's best execution requirements by introducing the terms of MiFID directly into their legislation or rulebooks. By copying-out, there will be harmonised Level 1 and Level 2 requirements. Beyond this, it is the responsibility of the competent authorities in each Member State to interpret and supervise compliance with these harmonised rules.

As harmonisation of regulation in the area of best execution is a key objective behind MiFID, CESR has an important role to play in promoting supervisory convergence in this area. To this end, CESR members set out their agreed views on a range of issues relating to best execution in Consultation Paper CESR/07-050b which was published in February 2007. CESR has published a separate Feedback Statement CESR/07-321 on the responses received to the Consultation Paper.

### *Objective of the Q&A*

CESR has prepared this paper in order to clarify key aspects of the CP. CESR has chosen a Q&A format in order to present its views in a user-friendly way that facilitates compliance by firms and convergence among competent authorities. This Q&A presents CESR's answers to practical questions raised by firms and competent authorities about how firms should be complying with the MiFID best execution regime. In this Q&A, CESR does not impose requirements on firms or otherwise go beyond what the Directives already require. Rather, the Q&A explains CESR's views on how firms can comply with the Directives in the particular circumstances and situations that stakeholders have raised.

### *Status of the Q&A*

Members of CESR will make use of this Q&A on a voluntary basis in their day-to-day supervisory practices. The Q&A does not constitute European legislation and will not require national legislative action.

The European Commission has participated as an observer in the course of CESR's work on best execution.

This Q&A is only intended to promote supervisory convergence and does not prejudice the role of the Commission as guardian of the Treaties.

### *Scope*

On 15 November 2006 CESR posed three questions to the European Commission in relation to the work it was undertaking on best execution:



1. In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?
2. What scope may "specific instructions" from a client cover?
3. In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?

The Commission's response is appended to this Q&A but does not form part of the Q&A itself. CESR has not addressed the scope of best execution under MiFID in this Q&A, nor has it addressed the question of how best execution applies in dealer markets.

The MiFID Level 3 Expert Group has considered the possibility of conducting a further public consultation following the Commission's reply to CESR and consulted the MiFID Consultative Working Group on this question to gain input from a wider group of stakeholders. Following this consultation, CESR considers that the Commission's reply forms a sufficient basis for implementation and that no further work is needed at the present time.

#### *Further work*

In devising its future work plan, CESR will consider reviewing how MiFID's best execution requirements are being applied as well as submissions and requests from the Commission, the Consultative Working Group and other stakeholders.

**Q1 Which provisions in MiFID relate to best execution?**

1.1 MiFID's best execution regime is set out as follows in the Directives. Article 21 of Level 1 and Articles 44 and 46 of Level 2 set out the requirements for investment firms that provide the service of executing orders on behalf of clients for MiFID financial instruments and, indirectly via Article 45(7), for investment firms that provide the service of portfolio management, when executing decisions to deal on behalf of client portfolios.

1.2 Article 45 of Level 2 (enacted under Article 19 of Level 1) sets out the requirements for (i) investment firms that provide the service of reception and transmission of orders, when transmitting orders to other entities for execution and (ii) investment firms that provide the service of portfolio management, when placing orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios. There are associated recitals in both Level 1 and Level 2 (Recital 33 of Level 1, and Recitals 66 to 76 of Level 2.)

1.3 Responses to the CP pointed out that investment firms may provide a combination of investment services to the same clients. For example, an investment firm may have the flexibility either to transmit an order on behalf of a client to another entity for execution or to execute the order itself. Similarly, an investment firm may have the flexibility to place orders resulting from its decisions to deal on behalf of client portfolios with other entities for execution or to execute such decisions to deal itself. To take account of this, the Q&A will refer to firms that "execute orders or decisions to deal" and to firms that "transmit or place orders with other entities for execution" rather than referring to "portfolio managers", "RTOs" and "investment firms that execute orders on behalf of clients." Where the Q&A means to refer only to investment firms when they execute orders on behalf of clients, it will refer to firms that "execute orders." The Q&A refers to all of these firms collectively as "firms that carry out orders."

**Q2 What is the overarching best execution requirement?**

2. MiFID's best execution regime requires investment firms to take all reasonable steps to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to order execution. CESR considers this requirement to be of a general and overarching nature. See Q3.

**Q3 What should firms do to comply with the overarching best execution requirement?**

3.1 The overarching best execution requirement sets a high level standard, allowing investment firms a considerable degree of flexibility on how to meet it. However, MiFID does require firms to comply with a number of specific provisions.

3.2 Firms that execute orders or decisions to deal should establish "execution arrangements" and an "execution policy" (Article 21) for complying with the overarching best execution requirement. In a similar way, firms that transmit or place orders with other entities for execution should establish



a "policy" (Article 45) for complying with the overarching best execution requirement. It follows that all of these firms should carry out orders on behalf of clients in accordance with their (execution) policies and/or arrangements.

3.3. In order to comply with the overarching best execution requirement, firms should ensure that appropriate (execution) policies and/or arrangements are effectively implemented for the carrying out of all orders. Firms however are not under an obligation to obtain the best possible result for each individual order; rather they should apply their (execution) policies to each order with a view to obtaining the best possible result in accordance with the (execution) policy.

3.4 All investment firms that carry out orders should also disclose "appropriate information" to clients about their (execution) policies and monitor and review their performance. See Q13 – Q18 and Q22-24.

**Q4 What is the content of the execution policy of a firm that executes orders on behalf of clients or decisions to deal on behalf client portfolios?**

4.1 An execution policy should set out the investment firm's strategy for obtaining the best possible result for the execution of its client orders, including the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

4.2 The execution policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when executing client orders or decisions to deal, as well as information on how those factors affect the firm's choice of execution venues for inclusion in the execution policy.

4.3 The execution policy should also set out the execution venues the firm uses. Article 21(3) states that the execution policy "...shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders". CESR understands this provision to mean that firms should include certain venues in their policy, not that the policy can omit other venues used by the firm. A firm may however in exceptional circumstances use venues not listed in its policy, for example on a provisional basis or to accommodate a client request to trade in an unusual instrument, with a view to satisfying the overarching best execution requirement. See Q13 through Q15 on disclosure about the execution policy.

**Q5 What are execution arrangements and how do they differ from the execution policy?**

5. The "execution arrangements" are the means that an investment firm employs to obtain the best possible result when executing orders or decisions to deal, while the "execution policy" may be understood as a document that describes the most important and/or relevant elements of those execution arrangements. See [Q7].

**Q6 What is the content of a policy for a firm that transmits or places orders with other entities for execution?**

6.1 The "policy" is the means that the investment firm employs to obtain the best possible result for its clients when it transmits or places orders with other entities for execution.



6.2 In particular, the policy should set out the strategy of the firm, the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

6.3 The policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when carrying out client orders, as well as information on how those factors affect the firm's choice of entities for inclusion in the policy.

6.4 The policy should also set out the entities the firm uses. In exceptional circumstances, however, a firm may use entities not listed in its policy (See Q4). See Q13 and Q16 on disclosure about the policy.

**Q7 How differentiated should the content of an (execution) policy be?**

7.1 The investment firm should differentiate its (execution) policy to the extent necessary to comply with the overarching best execution requirement.

7.2 The number of subsets in the (execution) policy will depend *inter alia* on the types of clients a firm serves, the types of financial instruments for which it accepts orders, and the relevant execution venues and entities available for those instruments.

7.3 A firm's (execution) policy will need at least to address the different classes of instrument for which it carries out orders. Examples of such classes are equities, debt instruments, units of collective investment schemes and derivatives (which would need to be further distinguished between exchange-traded derivatives and OTC products, if appropriate). The (execution) policy will also need to address the distinction between retail and professional clients to the extent that the firm treats each such category of clients differently. In addition to differentiating by class of instrument and client categorisation, an investment firm may wish to distinguish its policy further, for example by order type.

**Q8 Can a firm that executes orders or decisions to deal include only one venue in its execution policy?**

8.1 CESR considers that whenever there is more than one execution venue that would enable the investment firm to obtain the best possible result on a consistent basis, the firm should consider the respective merits of such venues. The firm should at least include those venues that enable it to obtain on a consistent basis the best possible result for the execution of its client orders or decisions to deal.

8.2 However, MiFID does not prohibit firms from selecting only one execution venue if the firm can show that by doing so it is able to obtain the best possible result on a consistent basis. For example, there may be circumstances where a particular execution venue will deliver the best possible result on a consistent basis for a given subset of the execution policy, or where the costs of including more than one venue in the execution policy (to the extent that such costs would be passed on to clients) would outweigh any price improvement to be gained by doing so (considered over a reasonable time frame). In such circumstances, it may be reasonable for the firm to include only one venue in its execution policy.

8.3 In order to comply with the requirement under Article 19(1) to act in the best interests of its clients, a firm should consider transmitting client orders instead of executing them itself where that



would deliver a better result for clients, provided the firm is authorised for reception and transmission of such orders.

**Q9 Can a firm that transmits or places orders with other entities for execution include only one entity in its policy?**

9. An investment firm that transmits or places orders with other entities for execution can include a single entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement. That is, where a firm transmits or places orders with a single entity for execution, the firm should determine that selecting only one entity complies with the overarching best execution requirement. In addition, the firm should reasonably expect that the entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative entities.

**Q10 How does a firm assess the relative importance of the best execution factors?**

10.1 Responsibility for assessing the relative importance of the best execution factors lies with the investment firm. A firm should take into account the following criteria when determining the relative importance of the best execution factors:

- the characteristics of the client, including the categorisation of the client as retail or professional;
- the characteristics of the client order;
- the characteristics of the financial instrument that is the subject of the order;
- the characteristics of the execution venues or entities to which that order can be directed.

10.2 For retail clients, the best possible result is determined in terms of the total consideration. See Q11.

**Q11 What is "total consideration"?**

11.1 Total consideration is the price of the financial instrument and the costs related to execution, including all expenses incurred by the client which are directly related to the execution of the order such as execution venue fees, clearing and settlement fees, and any other fees paid to third parties involved in the execution of the order.

11.2 For example, an investment firm that provides a service to retail clients with respect to shares admitted to trading on a regulated market will focus on the net cost (or net proceeds in the case of a sale) of executing the order on the venues available, and will direct the order to the execution venue or entity providing the best possible result in terms of total consideration. The firm may consider speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs and give them precedence over the immediate price and cost factors if they are instrumental in delivering the best possible result in terms of the total consideration to the retail client. Such implicit costs may be relevant for retail clients with respect to a large order in a relatively illiquid share, for example.

11.3 CESR considers that the concept of total consideration is relevant for the assessment of best execution for professional client orders too, because in practice a firm is unlikely to be acting reasonably if it gives a low relative importance to the net cost of a purchase or the net proceeds of a



sale. There may be circumstances, however, where other factors will be more important for professional clients and MiFID clearly allows firms flexibility in this regard.

**Q12 Can a firm take its fees and commissions into account when deciding between execution venues?**

12.1 With respect to investment firms that execute orders on behalf of clients, MiFID draws a distinction between the selection of venues to be included in the firm's execution policy and the choice between two or more venues contained in the execution policy for the execution of a particular transaction.

12.2 When selecting venues to be included in its execution policy, a firm should not take into account the fees and commissions that it will charge its clients. At this stage, the firm should focus on the potential of the venues to enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders. In other words, it should focus on the quality of execution available on the various venues.

12.3 When choosing a venue for the execution of a particular client order (from among the venues included in the firm's execution policy that are capable of executing such an order), the firm should take into account the effect of its own fees and commissions on the total consideration to the client.

12.4 For example, if a firm has included a regulated market and a systematic internaliser in its execution policy (or is itself a systematic internaliser) because both those venues enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders, the firm will need to take into account not only the prices displayed by those two venues, but also any difference in fees or commission it charges the client for executing on one venue rather than the other (as well as any other costs or other relevant factors). See Q13.

**Q13 Does MiFID regulate the fees and commissions a firm charges for the execution of client orders?**

13.1 Investment firms are free to set their fees or commissions at the level they choose, provided that no venue is unfairly discriminated against. A firm may not charge a different commission (or spread) for execution on different venues unless the difference reflects a difference in the cost to the firm. For example, a firm may not direct all its orders to another firm within its corporate group on the basis that it charges its clients a higher fee for access to other venues that is unwarranted by higher access costs.

13.2 MiFID contains specific disclosure requirements for retail clients regarding a firm's fees and commissions to ensure that these investors are able to compare the fee structures of different firms<sup>1</sup>. See Q14.

**Q14 What information about its (execution) policy should a firm disclose to its clients?**

14.1 An investment firm should provide appropriate information about its (execution) policy to its clients, rather than the full detail of its execution arrangements and/or policy. In this way, MiFID strikes a balance between requiring firms to disclose a lengthy trading manual which would be of

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<sup>1</sup> See Article 19(3) of Level 1 and Articles 33 and 40(4) of Level 2.





limited utility to clients and information that is too high level to enable an adequate understanding of a firm's (execution) policy by clients.

14.2 CESR considers that firms should disclose sufficient information, reflecting any relevant differentiation of the firm's (execution) policy (see Q7), to enable clients to make a properly informed decision about whether to utilise the services offered by the firm.

**Q15 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its *retail* clients?**

15.1 An investment firm executing orders or decisions to deal on behalf of retail clients should disclose the following in good time prior to the provision of the service:

- the relative importance the firm assigns to the best execution factors, or the process by which it determines their relative importance,
- a list of the execution venues on which the firm places significant reliance in meeting the overarching execution requirement,
- a warning to the client regarding the use of specific instructions.

15.2 CESR considers that where a retail client requests additional information about a firm's execution policy and such a request is reasonable and proportionate, the firm, by virtue of its duty to act fairly and professionally<sup>1</sup>, should consider honouring such a request, especially where such information is needed to enable the client to make a properly informed decision about whether to utilise, or continue utilising, the services of the firm.

**Q16 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its *professional* clients?**

16.1 An investment firm should provide appropriate information about its execution policy to its professional clients. There are no provisions within MiFID that detail what constitutes "appropriate information" for professional clients.

16.2 Firms should supply information to professional clients upon request provided the request is reasonable and proportionate. What is reasonable and proportionate will depend on the facts and circumstances of each particular situation.

**Q17 Is there additional information about its policy which a firm that transmits or places orders with other entities for execution should provide to its clients?**

17.1 A firm that transmits or places orders with other entities for execution should provide "appropriate information" on its policy to its clients.

17.2 This information should enable the client to understand the key aspects of the firm's policy. Depending on the circumstances, it may be appropriate to mention the relative importance of the factors or to describe the process used to select the entities. It will also be appropriate to mention the entities used, depending on the circumstances. For example, where an investment firm includes only a small number of entities in its policy, it may be appropriate to disclose them to clients.

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<sup>1</sup> See Article 19(1) of Level 1.





**Q18 What should a firm do if it amends its execution policy?**

18.1 An investment firm that executes orders or decisions to deal should notify its clients of any material changes to its execution arrangements or execution policy. A change is material where its disclosure is necessary to enable the client to make a properly informed decision about whether to continue utilising the services of the firm. In particular, a firm should consider the materiality of any changes it makes to the relative importance of the best execution factors or to the venues on which it places significant reliance in meeting the overarching best execution requirement.

18.2 There is no comparable requirement for firms that only transmit or place orders with other entities for execution but do not execute orders or decisions to deal.

**Q19 How should disclosure on the (execution) policy be presented?**

19.1 Investment firms should provide their clients with appropriate information in a comprehensible form.

19.2 A firm executing orders or decisions to deal on behalf of retail clients should provide the required information about its execution policy either in a durable medium or by means of a website under certain conditions<sup>1</sup>. Any such disclosure could be incorporated into the client agreement.

**Q20 How do clients consent to the execution policy?**

20.1 An investment firm that executes orders or decisions to deal should obtain the prior consent of its clients to its execution policy. CESR observes that for consent to be valid, the legal provisions of the relevant Member State relating to the giving of consent must be satisfied, without prejudice to what is said in Q14 through Q16 about the information that the firm should provide to clients.

20.2 A firm should obtain the prior express consent of its clients before executing their orders outside a regulated market or MTF.

20.3 There are no comparable requirements for firms when they transmit or place orders with other entities for execution but do not execute orders or decisions to deal themselves.

**Q21 What is the difference between "consent" and "express consent"?**

21.1 Where MiFID requires "prior express consent", CESR considers that this entails an actual demonstration of consent by the client which may be provided by signature in writing or an equivalent means (electronic signature), by a click on a web page or orally by telephone or in person, with appropriate record keeping in each case.

21.2 CESR considers that on a purposive reading of the "express consent" requirement, an investment firm does not have to obtain express consent from its clients where the relevant instruments are not admitted to trading on a regulated market or MTF.

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<sup>1</sup> See Articles 3(1) and 3(2) of Level 2.



21.3 CESR understands that "prior consent" may, at least in some jurisdictions, be tacit and result from the behaviour of the client such as the sending of an order to the firm after having received information on the firm's execution policy.

21.4 Competent authorities are empowered to require evidence from firms that tacit consent has been given by clients and may have access to any document and demand information from firms in this regard<sup>1</sup>. In particular, a firm may be asked to show that it has supplied clients with the appropriate information on its execution policy.

**Q22 In what respects and under what circumstances can a firm that transmits or places orders with other entities for execution rely on those entities to help it satisfy the overarching best execution requirement?**

22.1 MiFID clarifies that its best execution provisions are not intended to require a firm that transmits or places orders with other entities for execution to duplicate the efforts of its execution entities. Rather, a firm should determine that the entities it uses will enable it to comply with the overarching best execution requirement when placing an order with, or transmitting an order to, another entity for execution.

22.2 To this end, a firm should review the execution arrangements of the entities it wishes to use to determine whether they will allow the firm to comply with all its best execution requirements.

22.3 In determining whether an entity is likely to enable the firm to obtain the best possible result for its clients, a firm also may need to consider:

- whether the entity itself is subject to Article 21 for the relevant business, that is, whether the entity is an investment firm executing or receiving and transmitting orders on behalf of the firm and the entity has agreed to treat the firm as a retail or professional client;
- whether the entity will undertake by contract to comply with any or all of the MiFID best execution requirements in relation to the relevant business (with the result that it has contractual but not regulatory responsibilities for best execution); and
- whether the entity can demonstrate that it delivers a high level of execution quality for the kind of orders that the investment firm is likely to place with or transmit to it.

Furthermore, with respect to the relevant business, if an entity is subject to Article 21 or undertakes by contract to comply with Article 21, and the firm merely transmits or places orders with the entity for execution, taking few steps itself that affect execution quality, and the firm has determined that the entity has arrangements that will enable the firm to comply with its obligations under Article 45, then CESR considers that the firm will be able to place a high degree of reliance on that entity in order to comply with its own overarching best execution requirement. That is, in these circumstances, CESR considers that a firm would be complying with the overarching best execution requirement with respect to particular orders simply by placing them with or transmitting them to such entities. Of course, the firm would still be subject to the other requirements of Article 45, in particular the requirements to implement an appropriate policy and to monitor and review its effectiveness, including the execution quality actually delivered by such entities. And the firm could not continue to rely on an entity if its monitoring or review indicated that the entity was not, in fact, enabling it to obtain the best possible result for the execution of its client orders.

22.4 In addition, when devising its policy, a firm should consider whether it is reasonable simply to transmit or place orders with another entity for execution or whether it is necessary to exercise

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<sup>1</sup> See Articles 50(1)(a) and (b) of Level 1.



some additional control over how its orders are executed, in order to meet the overarching best execution requirement. Similarly, any actions the firm takes that may affect the quality of execution of the order should be consistent with the overarching best execution requirement. For example, where a firm gives specific instructions to an execution entity about how or where a particular transaction is to be executed, those instructions should comply with the overarching best execution requirement.

22.5 Firms are not restricted to using entities subject to MIFID for carrying out their orders. In order to be able to use an entity that is not subject to the MiFID best execution regime, in particular a non-EEA service provider, firms should ensure that the execution arrangements of such an entity allow them to comply with the overarching best execution requirement. Where the firm cannot satisfy itself that this is the case, it should not use such entities.

### **Q23 What is the requirement to review?**

23.1 Review is an overall assessment of whether the (execution) policy and/or arrangements include all reasonable steps that the investment firm could be taking to obtain the best possible result for the execution of its client orders. Specifically, the firm should consider whether it could consistently obtain better execution results if it were to:

- include additional or different execution venues or entities;
- assign a different relative importance to the best execution factors; or
- modify any other aspects of its (execution) policy and/or arrangements.

23.2 All investment firms should carry out reviews at least annually. A firm should also review its (execution) policy and/or arrangements whenever a material change occurs that could affect its ability to obtain the best possible result for the execution of its clients' orders. What is material will depend on the nature and scope of any change.

### **Q24 What is the requirement to monitor?**

24.1 Monitoring is the assessment, on a regular basis, of particular transactions in order to determine whether the investment firm has complied with its (execution) policy and/or arrangements, and whether the resulting transaction has delivered the best possible result for the client.

Monitoring may include comparing similar transactions:

- (i) on the same execution venue or with the same entity, in order to test whether a firm's judgement about how orders are executed is correct, or
- (ii) on different execution venues or entities chosen from among those in the firm's (execution) policy, in order to test whether the 'best' execution venue or entity is being chosen for a given type of transaction.

24.2 Where monitoring reveals that a firm has fallen short of obtaining the best possible result, the firm should consider whether this is because the firm has failed to follow its (execution) policy and/or arrangements or because of a deficiency in such policy and/or arrangements, and make appropriate amendments.



24.3 All investment firms should undertake monitoring, but the monitoring methodology is at the discretion of the firm. Where monitoring every transaction would be disproportionate, other approaches, such as appropriate methodologies for sampling, may suffice.

**Q25 Will the precise nature of review and monitoring vary depending on where a firm sits in a chain of execution?**

25.1 Investment firms that execute orders or decisions to deal will need to monitor and review the steps they are taking to deliver the best possible result, as well as the performance of the execution venues they are using.

25.2 Investment firms that transmit or place orders with other entities for execution may need to take different approaches to their review and monitoring requirements, depending on how much control they exercise over the way their orders are executed. A firm may merely send orders received or decisions to deal to an entity for execution, taking few steps itself that affect execution quality and therefore relying to a high degree on the entity with respect to how orders are to be executed; alternatively, it may provide that entity with more or less extensive instructions about how the order should be executed or take steps to manage the execution of the order itself before sending the order to an entity. In the second case, the firm should monitor and review its own actions and their impact on the execution quality it is obtaining.

25.3 In any event, firms that transmit or place orders with other entities for execution should review and monitor the execution quality of the entities they use.

25.4 In addition, if a portfolio manager is empowered to either execute its decisions to deal itself or to place orders with other entities for execution, then, as part of the review process, it should compare the performance of the entities it uses with its own performance in executing its decisions to deal.

**Q26 Is CESR currently undertaking any work on execution quality data?**

26.1 No. CESR will consider any request from the Commission to examine execution quality data or any other aspect of best execution and will report such requests as and when they are received. CESR will consider whether further work is needed in relation to best execution as part of the assessment of the MiFID work programme starting in November 2007.

**Q27 What is the outcome of CESR's call for evidence on article 21(5) of the Level 1 'demonstration of compliance'?**

27.1 An investment firm that executes orders or decisions to deal should be able to demonstrate to its clients on request that such executions have been carried out in accordance with its execution policy. After November 2008, with one year of practical experience of the MiFID rules, CESR will consider whether there is a need to do further work to align the practices in this respect.

### Section 3 - Definitions

*In the interests of clarity and simplicity, CESR has kept to the terminology used in MiFID and its implementing directive wherever possible. However CESR considers it useful to abbreviate certain of these terms and concepts in order to keep the length of this paper to a minimum and to make its contents as user friendly as possible. Non-MiFID terms have only been used where CESR considers such concepts useful aids to understanding the directive. These terms are defined here but CESR does not intend for these terms to supersede or add to the terms of the directives in any way.*

<b>Level 1</b>	Directive 2004/39/EC of 21 April 2004
<b>Level 2</b>	Directive 2006/73/EC of 10 August 2006
<b>MiFID</b>	Collectively Directive 2004/39/EC of 21 April 2004 and Directive 2006/73/EC of 10 August 2006
<b>Article 21</b>	Article 21 of Directive 2004/39/EC of 21 April 2004 (Level 1)
<b>Articles 44, 45 and 46</b>	Articles 44, 45 and 46 of Directive 2006/73/EC of 10 August 2006 (Level 2)
<b>(Execution) policy</b>	The "execution policy" under Article 21 and the "policy" under Article 45.
<b>Execute orders or decisions to deal</b>	Execute orders on behalf of clients, or execute decisions to deal on behalf of client portfolios when providing the service of portfolio management.
<b>Carrying out</b>	<p>(i) Executing an order on behalf of a client</p> <p>(ii) When providing the service of portfolio management, placing an order with an entity for execution that results from a decision to deal in financial instruments on behalf of a portfolio or executing a decision to deal in financial instruments on behalf of a client</p> <p>(iii) When providing the service of reception and transmission of client orders, transmitting client orders to other entities for execution</p> <p>The European Commission has confirmed its intention to give the term this meaning as used in the context of client order handling in Articles 47, 48 and 49 of Level 2</p>
<b>Execution venues</b>	Regulated markets, MTFs, systematic internalisers, market makers or other liquidity providers or entities that perform a similar function in third countries to the function performed by any of the foregoing (last paragraph of Article 44(1) of Level 2)
<b>Entities</b>	Natural or legal persons or other entities that either transmit or execute orders in financial instruments
<b>Best execution factors</b>	The factors listed in Article 21(1) of Level 1. These factors are also referred to in Article 45(4) of Level 2.
<b>Overarching execution requirement</b>	<b>best</b> The requirement under Article 21(1) and Article 45(4) to take all reasonable steps to obtain the best possible result for the execution of client orders, taking into account the best execution factors



**Transmit or place  
orders with other  
entities for execution**

Transmit client orders to other entities for execution when providing the service of reception and transmission of orders, or place orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios when providing the service of portfolio management.



**Appendix – European Commission response to CESR questions on scope**



**EUROPEAN COMMISSION**  
Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS  
Director

23.03.07

1179

Brussels, 19 March 2007  
G3 D(2007)

Mr. Eddy Wymeersch  
Chairman  
CESR  
Avenue de Friedland 11-13  
75008 Paris  
FRANCE

**Subject : Best execution – scope issues under Mifid and the implementing directive**

Dear Eddy,

Following Arthur Philippe's request of 15 November 2006 please find the Commission services' opinion on the three issues related to best execution for which CESR asked for clarification.

Yours sincerely

David WRIGHT

J:\A FS 80 SECURITIES\FS 80.30 ISD - MIFID\30.1 MIFID\30.1.8 Implementation\30.1.8.1Best execution

Commission européenne, B-1049 Bruxelles / Europese Commissie, B-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.

[http://ec.europa.eu/internal\\_market/](http://ec.europa.eu/internal_market/)



## WORKING DOCUMENT ESC-07-2007

### Commission answers to CESR scope issues under MiFID and the implementing directive

#### Issue 1 – Dealing on quotes

*In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?*

In many markets in financial instruments firms operate by providing 'quotes' (that is, prices at which they may be willing to buy or sell:

- continuously, such as for example, on a web-page or some limited access bulletin board; or
- to a particular person, such as, for example, in response to a 'request for quote' from that person, which is communicated electronically or over the phone, and then dealing with a person to whom they have made a quote.

In its consultation paper published on 31 October 2006, the UK FSA has suggested that best execution requirements do not necessarily apply to firms who operate in this way for either or both of the following reasons:

- (i) A firm operating in this way may not be providing an investment service, only performing an investment activity. That is, there is no client;
- (ii) A firm operating in this way does not receive a client order, because there can only be an order where the firm commits to do something on behalf of the client and the presumption is that there is no such commitment in this type of dealing. (An order would be, for example, where the firm commits to obtaining the best price.)

Other CESR members believe that the above-mentioned interpretation is not consistent with Art. 21 of MiFID and Art. 44 of the implementing directive because the "dealing on quotes" meets the criteria of dealing on own account. Dealing on own account with clients by investment firms should be considered as the execution of client orders and therefore is subject to the best execution requirements (Recital 69 of the implementing directive).

The interpretation according to which "dealing on quotes" does not amount to "dealing on own account" was expressly rejected in the negotiation of level 2 measures. The rationale behind was that such an interpretation runs against the approach adopted in the Level 1 regulatory framework.

According to MiFID, only eligible counterparties may be allowed to enter into transactions without benefiting of the best execution requirements. Apart from such an exception,

whenever an investment firm executes an order, it provides an investment service to a client, therefore best execution requirements apply.

Moreover, Art. 44(3) of the implementing directive expressly refers to the need of taking into account the client's nature (retail/professional) in order to achieve the best possible result.

The motive for not having exempted professional clients may be that the best execution rules not only serve the purpose of investor protection but also to foster the competition between execution venues and overall market efficiency. This is expressed in Art. 21(6) of MiFID ("fair and orderly functioning of markets") and Art. 44(4) of the implementing directive ("discriminate unfairly between execution venues").

#### Commission services' response

1. We do not consider it fruitful to distinguish between, on the one hand, cases where a service is being provided to a client and, on the other hand, those where an activity is simply being carried on *with* a person who is not a client. The Level 1 Directive provides no clear criterion for distinguishing between these two situations. It is clearly the case, for example, that carrying on the activity of dealing on own account can also involve the provision of a service to a client in some cases. This much is implicit in Recital 69 of the Level 2 Directive. Therefore, we do not believe this distinction should determine whether or not best execution is required in a particular case. Similarly, we do not believe it is useful to focus on the question of when an *order* arises. Again, this is consistent with Recital 69, which clarifies that whenever a firm deals on own account with a client there should be considered to be an order.
2. As a corollary, we believe that whenever a person or entity enters into a transaction with an investment firm, it will do so in the capacity either of an eligible counterparty, or as a retail or professional client.
3. As regards eligible counterparties, Article 24 of MiFID provides that best execution obligations under Article 21, together with conduct of business obligations under Article 19 and client order handling obligations under 22(1), do not apply. At the same time, as indicated by Recital 40 of MiFID, eligible counterparties should be considered to be acting as clients. One consequence of this is that the protections of Articles 13 and 18, relating *inter alia* to conflicts of interest and client assets, will continue to apply. As regards retail or professional clients, Articles 13, 18 and 19 of MiFID will always apply whilst the application of Article 21 will depend on what is said below.
4. In our view, the key concept to focus on in interpreting Article 21 is the execution of orders *on behalf of clients*. This is consistent with the definition in Article 4(1)(5) of MiFID, which refers specifically to a firm acting to conclude agreements to buy or sell financial instruments *on behalf of clients*, and the description of the relevant investment service in Annex I to MiFID as the "execution of orders on behalf of clients". Both provisions support the idea that the requirement that an order is being executed on behalf of a client is integral to the concept of best execution.
5. Recital 33 of MiFID provides some explanation of the concept of execution of orders *on behalf of clients*, by indicating that it will typically be present in a range of circumstances which are broadly referred to in that Recital as situations where 'contractual or agency

obligations' are owed by the firm to the client<sup>1</sup>. It is also important to note that Recital 33 of MiFID circumscribes the scope of Recital 69 of the level 2 Directive, so that the scope of best execution requirements in relation to dealing on own account is limited to circumstances covered by Recital 33 where the firm is acting on behalf of the client (and is thereby in a position to make decisions that will affect the interests of the client).

**Indicative examples of cases where a firm executes an order on behalf of a client and therefore best execution applies**

6. Applying the principles set out above, transactions based on a client's request to the investment firm to buy or sell a financial instrument for him will *always* fall within the concept of execution of an order on behalf of a client. This will include the following types:

- Executing a client order by dealing as agent for a client. In this situation, the intermediary takes a customer order and places the order, on behalf of the client, with an execution venue (such as an exchange, a systematic internaliser or another liquidity provider) for execution. For example, client A instructs investment firm B to buy 100 shares of X. The firm must then seek the execution venue that offers the best conditions for buying X shares at the time that the order is to be executed.
- Executing a client order against the firm's own proprietary position (including as a systematic internaliser), where the firm is making decisions as to how the order is executed: e.g. where it is 'working the order' on the client's behalf. For example, client A gives the same instruction as in the preceding example, but investment firm B sells 100 shares in X to client A from its own portfolio. In this case, B puts itself in competition with other relevant execution venues and can execute the client instructions by selling the shares from its portfolio, provided that in doing so it obtains the best result for the client as compared with the other execution venues surveyed.
- Executing a client order by dealing as a riskless principal on behalf of the client, including cases where the client is charged a spread on the transaction. In this type of transaction, the investment firm will typically deal as principal with its client at the same time, and on the same terms (as to instrument, time and price (allowing for any spread)), as it enters a transaction as principal with a counterparty.

**Indicative examples of transactions where a firm generally does not execute an order on behalf of a client and therefore does not owe an obligation of best execution to its client**

7. Transactions based on a specific request by the client to buy or sell a financial instrument from the investment firm, or on the acceptance by the client of an offer made by the firm to buy or sell a financial instrument from the firm, will typically not fall within the concept of execution of an order on behalf of a client unless in all the circumstances, taking into account the considerations set out in paragraph 8 below, the firm should properly be regarded as acting on behalf of the client. This class of transactions will include the following type:

<sup>1</sup> However, the reference to 'agency' in Recital 33 is not intended to equate the application of best execution obligations with the existence of an agency relationship under the applicable national law.

- Executing a client order by entering a proprietary trade with the client in those cases not covered by paragraph 6 above. This includes the case where the firm engages in proprietary trading by quoting on a 'request for quote' basis. For example, client A requests a quote from investment firm B for 100 shares of X. The firm provides a quote which the client accepts and asks to buy 100 shares at the price quoted by B. By way of further example, B is a market maker that displays its quotes and Client A "hits" the quote displayed by B.
8. However, in some cases, proprietary trades will attract the best execution obligation. The application or otherwise of best execution will depend on whether the execution of the client's order can be seen as truly done *on behalf of* the client. This is a question of fact in each case which ultimately depends on **whether the client legitimately relies on the firm to protect his or her interests in relation to the pricing and other elements of the transaction - such as speed or likelihood of execution and settlement - that may be affected by the choices made by the firm when executing the order.** The following considerations, taken together, will help to determine the answer to this question:
- whether the firm approaches (initiates the transaction with) the client or the client instigates the transaction by making an approach to the firm. In those cases where the firm approaches a retail client and suggests him to enter into a specific transaction it is more probable that the client will be relying on the firm, to protect his or her interests in relation to the pricing and other elements of the transaction.
  - questions of market practice will help to determine whether it is legitimate for clients to rely on the firm. For example, in the wholesale OTC derivatives and bond markets buyers conventionally 'shop around' by approaching several dealers for a quote, and in these circumstances there is no expectation between the parties that the dealer chosen by the client will owe best execution.
  - the relative levels of transparency within a market will also be relevant. For markets where clients do not have ready access to prices while investment firms do, the conclusion will be much more readily reached that they rely on the firm in relation to the pricing of the transaction.
  - the information provided by the firm about its services and the terms of any agreement between the client and the investment firm will also be relevant, but not determinative of the question. The use of standard term agreements to characterise commercial relationships otherwise than in accordance with economic reality should be avoided.
9. These factors are likely to support the presumption that, in ordinary circumstances, a retail client legitimately relies on the firm to protect his or her interests in relation to the pricing and other parameters of the transaction. Similarly, *prima facie* application of these factors is likely to lead to the presumption that in the wholesale markets clients do not rely on the firm in the same way.

## Issue 2 - Use of Specific Instructions

*What scope may "specific instructions" from a client cover?*



Investment firms are considered to meet their best-execution obligation in respect of specific client instructions for an order or an aspect of an order.

Recital 68 clarifies that when an investment firm executes an order following specific instructions from the client, it should be treated as having satisfied its best execution obligations only in respect of the part or aspect of the order to which the client instructions relate. This provision should not be used by firms to avoid their duty of best execution. In particular, firms should not "suggest" instructions from their clients and thus avoid complying with their obligation.

**Commission services' response**

10. Recital 68 of the Level 2 Directive must be read in its entirety. In particular, the clarification that a firm should not solicit a specific instruction by expressly indicating or implicitly suggesting the content of an instruction to a client is limited to those circumstances "when the firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client". So, a firm that 'suggests' instructions to a client should not be considered as avoiding best execution in all cases.
11. For example, a client chooses to use a Direct Market Access system, such that he himself selects parameters of the trade (such as the price, the counterparty, the venue, the timing and the size of trade). In such a case the dealer, while acting on the client's behalf in providing the DMA service, will be treated as having satisfied its duty of best execution to the extent that the client has given specific instructions by means of the DMA system.

The scope for specific instructions deserves legal clarifications as regards, at least, its application in customised products.

Regarding application of the best-execution to customised products (e.g. an Over-The-Counter product), where the client indicates the particular characteristics of the product that he/she wants, can this specification of the characteristics be considered 'specific instructions'? Or, as recital 70 of the implementing directive already provides for a differentiated approach to best execution, should this be dealt with not as a scope issue but as an issue of the relevant standard of best execution? Or, in case of complex products, should we consider that the best execution requirement applies to each of the single components of the product?

**Commission services' response**

12. Best execution applies to OTC customised instruments in those cases when the firm is considered to be acting on behalf of the client. This will depend on the factors set out in our answer to issue 1. A customised instrument should be understood as that instrument which is tailored to specific needs of a client and for which there is practically no liquidity. On the contrary, an OTC plain vanilla option on a single liquid share with a maturity of one month should not be considered as a customised instrument.
13. The fact that the client specifies what he needs in terms of exposure and protection does not necessarily exclude the application of best execution. In the first stage where an investment firm proposes to a client the elements of an OTC derivatives contract that would respond to the client's needs, it is more appropriate to speak of investment advice rather than best execution. For example, a client may ask an investment firm to design an instrument that will protect him against a collapse in gas prices and a spike in the price of

electricity. The investment firm may propose a number of alternatives with different pay-off structures and advise the client to select one particular design meaning the suitability obligations apply. Best execution obligations could apply depending on the considerations set out in our answer to issue 1.

14. Ordinarily, in those circumstances where best execution applies, the identity of the instruments sought will be a matter of the information contained in the order rather than a question of specific instructions. Nevertheless there may be a level of discretion as to exactly which instruments to obtain on behalf of a client in the order.

15. In the case of complex products<sup>2</sup>, the best execution requirement (when applicable) applies to the product as a whole. Best execution for the product as a whole may conceivably be obtained even if best execution for each component, when considered in isolation, is not obtained.

### Issue 3 – Obligations on portfolio managers and order receivers and transmitters

*In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?*

Some take the view that portfolio managers execute client orders when they deal directly with execution venues, including direct access to regulated markets as well as use of MTFs, investment firms that deal on own account and other liquidity providers and counterparties.

Others take the view that portfolio managers never execute client orders, except possibly where they arrange transactions between their clients ("agency cross transactions"). For transactions in quote driven markets, some argue that portfolio managers are price takers, not makers, and that, for this reason, they are not 'executing client orders'. Rather, it is the dealer who executes.

In addition, some investment firms that provide retail brokerage services suggest that they themselves only receive client orders and transmit them to other investment firms, it is these other firms that take responsibility for executing these orders. Is there any clear line that can be drawn between reception and transmission of client orders for execution and execution of client orders? Is it possible for two firms in a chain of execution both to be viewed as executing those orders?

These questions are particularly relevant for the operation of Article 45(7) of the Implementing Directive and Article 66 of the Level 1 Directive. Article 45(7) provides that Article 21 (not Article 45) applies to portfolio managers and order receivers and transmitters when they execute client orders.

The requirements under Article 45 are not as extensive as those under Article 21. Therefore, brokerage firms and portfolio managers have an incentive to characterise their business models as something other than execution of client orders.

If portfolio managers do execute client orders when they deal on quote driven markets or deal "direct" via regulated markets or MTFs, then there is a question about what Article 45(7) means for portfolio managers authorised under the UCITS Directive. This is because MiFID Article 66 only applies MiFID Articles 2(2), 12, 13 and 19 to UCITS portfolio managers but not Article 21. Does MiFID apply to transactions by UCITS portfolio managers when they execute client orders?

### Commission services' response

<sup>2</sup> We understand complex products as those that are composed of or represent the performance of more than one product.

16. Since the "execution of orders on behalf of clients" is a distinct investment service, it could be argued that only those entities licensed to provide this particular service can execute orders or decisions to deal on behalf of clients. This would mean that investment firms authorised to provide portfolio management services<sup>3</sup> may transact directly with execution venues (i.e. execute decisions to deal) only if they are authorised to provide the service of execution of orders on behalf of clients.
17. The consequence of this reading would be to prevent UCITS management companies from transacting directly with execution venues when providing the investment service of individual portfolio management under Article 5 of the UCITS directive.
18. In accordance with this reading, in such cases Article 45(7) of the implementing Directive will simply not apply because those entities cannot provide the service of execution of orders, and the question as to whether Article 21 applies to UCITS management entities providing the service of portfolio management would be irrelevant.
19. However, the MiFID implementing Directive supports a different interpretation of the relevant provisions which is more consistent with current business practices and also ensures the level of investor protection and gains in market efficiency which the best execution obligations are designed to secure. Under this interpretation, an authorisation to provide the service of portfolio management under Article 5(3) of the UCITS Directive is treated as entitling portfolio managers to execute their own decisions to deal. However, if, when executing the decisions to deal, those persons should be required to comply with the same obligations as those under Article 21 of the MiFID. Any other outcome would compromise investor protection.
20. Article 45(7) of the Level 2 Directive implies that persons who are authorised to carry out portfolio management are not considered to provide the MiFID service of executing orders on behalf of clients when executing decisions to deal in the course of the activity of portfolio management, because there may not necessarily be any client orders when the portfolio manager decides to initiate a transaction on behalf of a client's portfolio.
21. However, the Level Directive 2 recognises that the same policy concerns arise in situations when a portfolio manager executes a decision to deal as are present when an investment firm executes an order on behalf of a client. Indeed, in both cases, transactions are executed on behalf of clients, be they clients under management or clients placing orders. In fact, there seems to be little or no difference, in so far as the interests of the client are at stake, between a situation where a client receives advice from an investment firm and acts on this advice by issuing an order to an investment firm for execution and a situation where a portfolio manager executes a decision to deal directly with an execution venue. In both cases the client needs to be able to rely on the firm's expertise to deliver the best possible result for the transaction.
22. This is why Article 45(7) of the Level 2 Directive provides that when an investment firm that provides the service of portfolio management transacts or deals directly with an execution venue (i.e. executes a decision to deal), it should comply with the obligations under Article 21 of MiFID.

<sup>3</sup> Thus bringing them within the scope of MiFID. Collective investment undertakings that do not carry on individual portfolio management (or any other investment service of activity regulated under MiFID) are excluded from the scope of MiFID (Article 2(1)(h)).

23. This means that UCITS asset managers and investment firms, when executing orders directly (rather than transmitting them to an intermediary who would execute them on their behalf) in the course of providing the service of individual portfolio management, will have to comply with the obligations under Article 21. This is necessary in order to ensure adequate investor protection.

**Reception and transmission**

24. There should be a clear regulatory distinction between a firm that is authorised both to receive and transmit orders and to execute them and a firm that may only receive and transmit client orders for execution to another investment firm. The latter firm may not in any way alter client instructions as it transmits them to another firm for execution or further transmission.

25. Execution of a client order or a decision to deal is always carried out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue. Clearly, an investment firm may be the first and the last link in the chain: for example, when a client order is executed by an investment firm in its capacity as systematic internaliser.

26. A firm which is authorised both to receive and transmit orders and to execute orders on behalf of clients will need to comply either with Article 21 of MiFID or with the requirements under Article 45 of the MiFID implementing Directive, depending on whether the investment firm transacts directly with the execution venue or transmits the order to another firm for execution. In cases where the investment firm transacts directly with the execution venue, Article 21 of MiFID always applies.

27. Sometimes an investment firm that is authorised to execute orders but acting in its capacity as a receiver and transmitter of orders, issues instructions to another executing firm which are not client instructions and which may affect the quality of execution of the order. In such cases, the instructing firm must comply with Article 45 of the implementing Directive. Execution of the order is carried out by the last firm in the chain.

28. The firm which receives instructions (which are not client instructions) from another investment firm should comply with any instructions passed on to it, treating them as if they were client instructions for the purposes of Article 21(1). However, it must deliver best execution in respect of any part of the order which is not covered by an instruction.





THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/06-552c

**CESR Level 3 Recommendations on the List of  
minimum records in article 51(3) of the MiFID  
implementing Directive**

February 2007



## INTRODUCTION

Article 13 (6) of the Directive 2004/39/EC (hereinafter 'Level 1') establishes that investment firms shall arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under the Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients or potential clients.

Article 51(3) of the Directive 2006/73/EC (hereinafter 'Level 2') establishes that competent authorities shall draw up and maintain a list of the minimum records investment firms are required to keep under MiFID and its implementing measures.

CESR is hereby issuing a recommendation to its members with the content of the list of minimum records that competent authorities need to draw up according to article 51(3) of Level 2. This list is without prejudice of other record keeping obligations arising from other legislation.

The list of minimum records in Level 2 is non-exhaustive and should not be understood as a limitation of the scope of Level 1 and Level 2. CESR understands that compliance with the list does not provide investment firms with a safe-harbour from the record-keeping provisions in Level 1 and Level 2.

It is important to note that CESR is not proposing to harmonise at this stage the content, timing, or form of the different records in the list.

The list does not refer to any of the policies that firms need to maintain pursuant to MiFID. CESR is of the opinion that all such policies need to be kept in writing.

Competent authorities may add to this list other record keeping obligations that they deem fit. CESR is at this stage trying to reach progressive convergence on the basis of the proposed list of minimum records. During 2008, CESR will conduct a review of competent authorities approach to the list of minimum records of article 51(3) of Level 2 with a view to harmonise further in this area.

CESR has consulted on the recommendations to its members. The vast majority of CESR stakeholders is of the opinion that both investors and industry will benefit from a common approach to the list that the different competent authorities have to draw up. This is in line with our objectives of (i) promoting common implementation of MiFID, (ii) fostering supervisory convergence, (iii) facilitating the cross-border provision of investment services and activities, and (iv) ensuring a common minimum basis for investor protection. A feedback statement explains the reasons for the final CESR decisions.

List of minimum records of article 51(3) of the MiFID implementing Directive <sup>1</sup>		
Type of record	Indicative contents of record	Indicative time at which record be created
Identity and categorisation of each client	The identity of each client and sufficient information to support categorisation as a retail client, professional client and/or eligible counterparty	When the client relationship begins or upon re-categorisation, including as a result of any review
Client agreement	Records provided for under Article 19(7) of the directive.	Before providing services to a new client for the first time
Client details (Article 19(4))	The information about the client's or potential client's knowledge and experience, financial situation and investment objectives, relevant to the specific product or service, obtained by the investment firm in complying with its obligation under Article 19(4) of the Directive	On giving advice or being appointed as a portfolio manager
Client details (Article 19(5))	The information about the client's or potential client's knowledge and experience, relevant to the specific product or service, obtained by the firm in complying with its obligation under Article 19(5) of the Directive	Upon providing the relevant service
Records required under Article 25(2)	The information required under Article 25(2) of the Directive	Such records should be kept for the period required by Article 25(2)
Aggregated transaction that includes two or more client orders, or one or more client orders and an own account order	Identity of each client; whether transaction is in whole or in part for discretionary managed investment portfolio and any relevant proportions as well as the intended basis of allocation	On executing an aggregated transaction and before the transaction is executed when the intended basis of allocation is contemplated.
Allocation of an aggregated transaction that includes the execution of a client order	The date and time of allocation; relevant financial instrument; identity of each client and the amount allocated to each client	Date on which the transaction is allocated
Re-allocation	The basis and reason for any re-allocation	At the time of the re-allocation

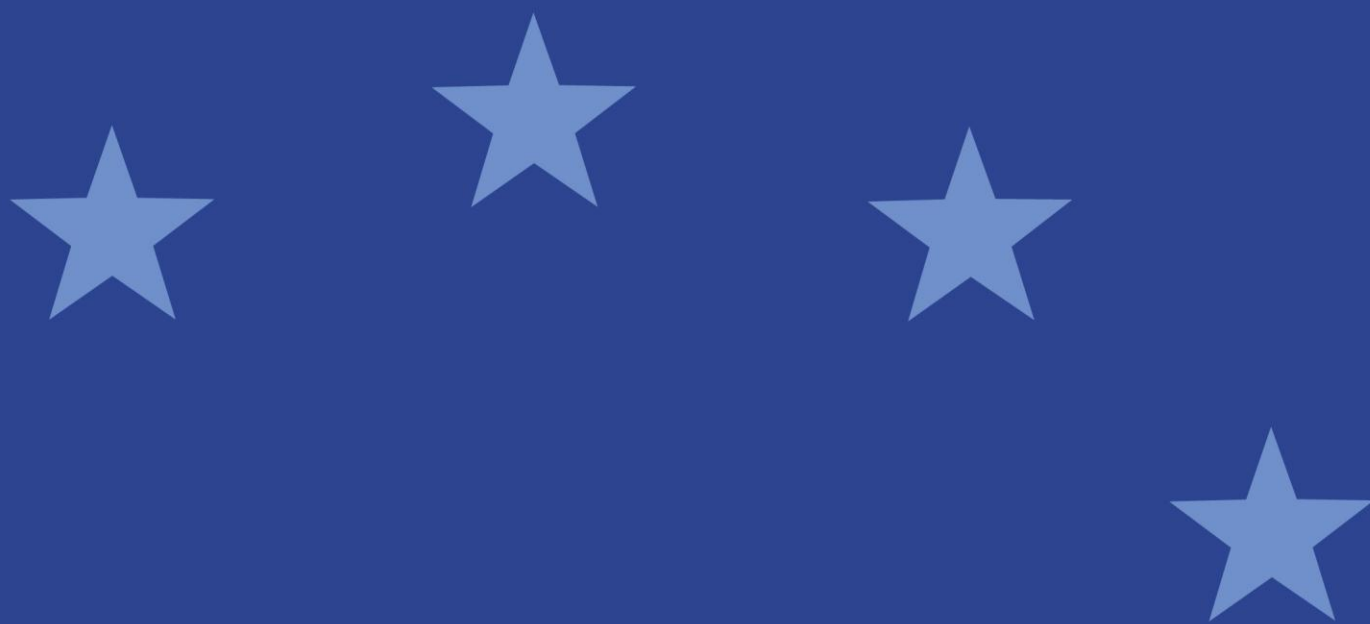
<sup>1</sup> This list is not exhaustive of the Level 1 obligation on record-keeping.

Order received or arising or decision to deal taken in providing the service of portfolio management	The records provided for under Art. 7 of the Regulation (EC) 1287/2006. Firms may wish to consider the date and hour that the order was sent by the investment firm for execution	Immediately after receipt of the order or after taking the decision
Orders executed on behalf of clients	Records provided for under Art. 8(1) of the Regulation 1287/2006	At the time of the execution of the order
Transactions effected for own account	The records provided for under Art. 8(1) of the Regulation (EC) 1287/2006	Immediately after the transaction is carried out
Transmission of order received by the investment firm	The records provided for under [Article 7 and] Article 8(2) of the Regulation (EC) 1287/2006	Immediately after [receipt and] transmission of the order and immediately after receiving the confirmation that an order has been executed
Periodic statements to clients	Information to evidence the content and the sending of the periodic statement to the client in respect of services provided, either as a copy, or in a manner that would enable reconstruction	On date on which it is sent
Client financial instruments held by an investment firm	The records required under Articles 13(7) of MiFID and under Articles 16.1(a) and (b) of Directive 2006/73/EC	On commencement of the holding
Client financial instruments available for, and subject to, stock lending activities	The identity of client financial instruments that are available to be lent, and those which have been lent as well as information to evidence client consent (note also the requirements under Articles 13(7) of MiFID and Article 19 (2) last paragraph of Directive 2006/73/EC, where applicable)	On such assets being made available for lending and on such assets being lent
Client funds	Sufficient records to show and explain investment firm's transactions and commitments under Article 8 of Regulation 1287/2006 (note also the requirements under Articles 13(8)) of MiFID and under Articles 16.1(a) and (b) of Directive 2006/73/EC	As soon as monies received and paid out
Marketing communications(except in oral forms)	Sample of each marketing communication addressed by the investment firm to retail clients or potential retail clients	At the time the investment firm first issues the marketing communication
Investment research	Each item of investment research, in accordance with Article 24(1) of Directive 2006/73/EC issued by the investment firm in writing	At the time the investment firm first issues the item of investment research
The firm's business and	Records provided for under Art. 5 (1)f of	On the business and organisation

internal organisation	Directive 2006/73/EC	being established or amended
Compliance procedures	The investment firm's essential compliance procedures, under Article 6(1) of Directive 2006/73/EC	On the procedures being established or amended (in respect of each version the period in Article 51(1) of Directive 2006/73/EC shall commence is the date on which the relevant version is amended)
Services or activities giving rise to detrimental conflict of interest	The services or activities under Art. 23 of Directive 2006/73/EC	At the time the conflict of interest is identified
Compliance reports	Each compliance report to senior management, under Articles 6(3)b and 9(2) of Directive 2006/73/EC.	At time of the relevant report
Risk management reports	Each Risk management report to senior management under Art. 7(2)b and 9(2) of Directive 2006/73/EC	At time of the relevant report
Internal audit reports	Each internal audit report to senior management, under Articles 8(d) and 9(2) of Directive 2006/73/EC	At the time of the relevant report
Complaints records	Each complaint referred to in Article 10 of Directive 2006/73/EC received	On receipt of complaint
Complaints handling	The measures taken for the resolution of each such complaint, according to Art. 10 of Directive 2006/73/EC	As measures are taken
Records of prices quoted by systematic internalisers	The quoted prices under Art. 24 para 1b of the Regulation (EC) 1287/2006	As prices are quoted
Records of personal transactions	The information required under Art 12(2)(c) of Directive 2006/73/EC	As notifications of personal transactions are received by the firm or when the firm identifies them
Record of the information disclosed to clients regarding inducements	The information disclosed to clients under Art 26 of Directive 2006/73/EC	As the information is disclosed
Investment advice to retail clients	(i) The fact that investment advice was rendered and (ii) the financial instrument that was recommended.	Upon providing investment advice

# Final report

Guidelines on certain aspects of the MiFID suitability requirements





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## **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 (MSG) 'Advice to ESMA' on that CP (dated 15 February 2012, ref: ESMA/2012/MSG/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 MSG 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.

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7. Section II sets out the feedback statement.
8. Annex I sets out the advice of the MSG; 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 in 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<sup>1</sup>**

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#### **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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<sup>1</sup> 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.

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## **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 restructuring of the client portfolio leads to a portfolio turnover and potentially to high costs. The same risk lies with portfolio management services. Portfolio restructuring 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 restructuring.

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 ("Swedsec Licence"). In France, a compulsory certification of investment firm staff, and



especially of sales persons, was established and entered into force in July 2010.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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

<sup>2</sup> Art. 313-7-1 of the General Regulation of the Financial Markets Authority (*RGAMF*).

<sup>3</sup> On the RDR, See. <http://www.fsa.gov.uk/about/what/rdr>.

<sup>4</sup> 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.<sup>5</sup> Paragraph 30 of the Guidelines, referring to article 35 of the MiFID Implementing directive<sup>6</sup>, 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

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<sup>5</sup> Articles 19(1) and (4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.

<sup>6</sup> 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 MSG 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.<sup>7</sup>

#### 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.<sup>8</sup> 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

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<sup>7</sup> 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.

<sup>8</sup> See. FSA, Final Notice Barclays Bank Plc, 14th January 2011 available at [www.fsa.gov.uk/pubs/final/barclays\\_jan11.pdf](http://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<sup>9</sup>, 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:

<i>Markets in Financial Instruments Directive (MiFID)</i>	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
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<sup>9</sup> 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.<sup>10</sup> 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

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<sup>10</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.



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.<sup>11</sup> 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

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<sup>11</sup> 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.<sup>12</sup>

#### *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.<sup>13</sup>
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

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<sup>12</sup> Adequate records about the suitability assessment should also be kept, as illustrated in guideline 9.

<sup>13</sup> 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.<sup>14</sup>

##### *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)**

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<sup>14</sup> 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<sup>15</sup> or risky<sup>16</sup> 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.<sup>17</sup>

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<sup>15</sup> As defined in MiFID.

<sup>16</sup> 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.

<sup>17</sup> 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<sup>18</sup>, 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.

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<sup>18</sup> 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'<sup>19</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 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<sup>20</sup> to provide an investment advice or portfolio management service that is suitable for the client, it must not provide such service to that client.<sup>21</sup>

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<sup>19</sup> As set out in Section I of Annex II of MiFID ('Categories of client who are considered to be professionals').

<sup>20</sup> 'Sufficient information' should be understood as meaning the information that firms must collect to comply with the suitability requirements under MiFID.

<sup>21</sup> 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.<sup>22</sup>

#### *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:

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<sup>22</sup> 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.