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Regulatory News Alert

ESMA guidelines on certain aspects of the MiFID II suitability requirements

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Introduction and context

On 6 November, the European Securities and Markets Authority (ESMA) has issued the official translations of its Guidelines on certain aspects of the MiFID II suitability requirements ("Guidelines").

National Competent Authorities (NCAs) have two months to notify ESMA whether they comply or intend to comply with the Guidelines.

Content of the Guidelines

The Guidelines build on the text of ESMA's 2012 MiFID I guidelines on **suitability**, which have been largely confirmed and broadened in order to consider technological developments, notably the increasing **use of automated systems** for the provision of investment advice or portfolio management (robo-advice) and provide additional details on some aspects that were already covered under the 2012 guidelines.

The Guidelines are divided in the following main sections:

- Information to clients on the purpose of suitability assessment
- Know your client" and "know your product"
- Matching clients with suitable products
- Other requirements

Information to clients on the purpose of suitability assessment

Firms should provide clients with the **clear and simple information on the purpose of the suitability assessment**, which is to enable them to act in the client's best interest. This should include a clear explanation that it is the firm's responsibility to conduct the assessment, so that clients understand the reason why they are asked to provide specific information and the importance that such information is up-to-date, accurate and complete.

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The Guidelines include additional conditions in case a **service is provided through robo-advice. These include** clear explanations about the extent of human involvement, and how the client can ask for such interaction, a description of the sources of information used to generate an investment advice or to provide the portfolio management service).

"Know your client" and "know your product"

It is recalled that firms should consider different elements of the client life (such as client's marital status, family situation, age, employment situation and similar) which would enable them to **understand their clients' needs and objectives** (e.g. using clear and comprehensive questionnaires).

In the spirit of the European Commission Action Plan 'Financing Sustainable Growth', setting out an ambitious and comprehensive strategy on sustainable finance, the Guidelines in addition suggest as a good practice to consider **client's preferences on environmental, social and governance factors** when gathering information on the client's investment objectives, hence anticipating the upcoming MIFID II changes.

The **extent of information** to be collected from clients should be based on **proportionality principle** (slightly diverging from the consultation proposal), hence take into account the features of the investment advice or portfolio management services to be provided, the type and characteristics of the investment products to be considered and the characteristics of the clients. ESMA however warns that this should not lead firms to lower the level of protection due to clients.

Firms remain responsible to check that the information collected about their clients is **reliable and consistent**, without unduly relying on clients' self-assessment.

Where a firm has an ongoing relationship with the client, in order to be able to perform the suitability assessment, it should define what part of the client information collected **should be subject to updating and at which frequency**. It should be clear how the updating should be done and what action should be undertaken when updated information is received or when the client fails to provide the information requested, what might lead to a rewrite of current procedures.

Suitability assessment in situations where a **client is a legal person or a group of two or more natural persons** should be defined in a policy in order to specify who should be subject to the assessment, how the assessment will be done in practice and the possible impact this could have for the relevant clients.

Matching clients with suitable products

Firms are reminded that the suitability assessment is **not limited to recommendations to buy a financial instrument** and therefore it may lead to a recommendation **to buy, hold or sell** an instrument, or not to do so.

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.

When making a decision on the methodology to be adopted to conduct the suitability assessment, the firm should also take into account the **type and characteristics of the services provided.**

When a firm conducts a suitability assessment **based on the consideration of the client's portfolio as a whole**, it should ensure an appropriate degree of diversification within the client's portfolio.

If suitability assessment is **conducted through automated tools**, firms should **regularly monitor and test the algorithms**.

ESMA introduced **two new guidelines on equivalent products and switching investments**. In this regard, firms should undertake a thorough assessment of the **possible investment alternatives** before making a decision on the investment product(s) that will be recommended and should be able to justify those situations where a more costly or complex product is chosen over an equivalent product. In addition, an **analysis of the costs and benefits of a switch** should be undertaken such that firms are reasonably able to demonstrate that the expected benefits of switching are greater than the costs.

Other requirements

ESMA is of the view that firm staff involved in material aspects of the suitability process need to have **adequate qualifications and skills**, including, where relevant, the staff involved in the activities related to the definition of automated tools.

As it is already the case, firms should continue to **keep records regarding the suitability assessment**, including the collection of information from the client, any investment advice provided and all investments made.

Next steps

The Guidelines will **take effect as from about 120 days** (i.e. 60 calendar days after the two-month period when competent authorities must notify ESMA whether they comply or intend to comply with the guidelines). The previous ESMA guidelines issued under MiFID I will cease to apply on the same date.

How Deloitte can help you?

Deloitte’s advisory specialists and dedicated services will also help you design and implement your business strategy in light of the future evolution of the regulatory framework and market trends.

Deloitte has developed D.Ready for MIFID II, a service that allows you to assess, evidence and help remediate potential gaps in your MIFID II implementation, that service might also help you to prepare for external reviews

Deloitte can also help you with its RegWatch Kaleidoscope service to stay ahead of the regulatory curve to better manage and plan upcoming regulations.

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