RegCORE – Client Alert

ESMA expands on how to interpret the definition of investment advice

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Financial Services

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QuickTake

On 11 July 2023, the European Securities and Markets Authority (**ESMA**) published a Supervisory Briefing[1] "on understanding the definition of advice under MiFID II". This revisits and replaces the 2010 Q&A as published by ESMA's predecessor, the Committee of European Securities Regulators (**CESR**)[2] entitled "Understanding the definition of advice under MiFID). Like CESR, the ESMA publication aims to define and thus delineate, including according to five key tests, what constitutes and what does not form the regulated activity of "investment advice".

As the ESMA Supervisory Briefing notes, "The CESR document has proven to be a useful and valuable supervisory convergence tool over these years and is still applied by firms and national competent authorities (**NCAs**). Considering that the legal definition of investment advice has substantially remained unchanged from the MiFID I to the MiFID II framework, ESMA has deemed it beneficial to update the content of the CESR document, in particular in light of the evolution of business models and technology (for example, increased use of social media and mobile apps by firms). ESMA has also deemed it useful to transform the Q&As into a supervisory briefing for NCAs to use in their supervisory activities."[3]

In many ways, ESMA's update is long overdue. Firstly, technological developments since 2010 have fundamentally changed the way investment advice is provided. Secondly, the EU's recent May 2023 publication of the equally long-awaited Retail Investment Strategy[4] calls for a rethink of certain regulatory

[1] Available here.
[2] Available here.
[3] That being said, ESMA notes in para. 3 that "The content of this briefing is not exhaustive, does not constitute new policy, and does not promote any particular way of supervising the rules. It has been designed to be used in a manner which best fits with supervisors' methodologies (whether distributing the briefings internally, or passing them to external bodies, such as auditors, for example)."
[4] See series of coverage from our EU RegCORE as well as the EU's publication available here as well as specifically on finfluencing available here. The EU Retail Investment Strategy also calls for a common harmonised standard of qualifications and competence to be evidenced by those providing investment advice. This follows on from similar reforms advanced individually by different EU Member States (including the UK while it was part of the EU) since MiFID I and subsequently MiFID II's introduction.

principles in the context of what CESR had covered. Despite the title, those proposed reforms go much further than just affecting retail clients and investors. Thirdly, CESR commented on the then applicable MiFID regime, since replaced by MiFIR/MiFID II and the IFR/IFD regime, as supplemented by implementing and technical standards and as implemented across the EU-27 (collectively, unless the context requires otherwise, the **MiFIR/MiFID II regime**). As such ESMA's Supervisory Briefing supplements CESR past efforts and sets out ESMA and NCAs supervisory expectations in relation to investment firms, including credit institutions, UCITS management companies and alternative investment funds managers (AIFMs) providing investment advice to clients. Four "practical cases" in Chapter 4 of the Supervisory Briefing provide further illustrations of how the five key tests as well as how ESMA's supervisory expectations apply in practice.

This Client Alert looks at some of the key points regulated firms should consider but also on how to delineate with "corporate finance advice" as an "ancillary service" under the MiFIR/MiFID II regime, for which a number of firms do not require authorisation. Given the fine line between corporate finance advice activity and the regulated service of investment advice, a number of corporate finance advisers will want to ensure they can remain compliant with "just" providing an ancillary service.

What is a personal recommendation anyway?

A personal recommendation, is defined in MiFID II and the framework of implementing and regulatory technical standards[5], as "a personal recommendation is a recommendation that is made to a person in his/her capacity as an investor or potential investors, or in his/her capacity as an agent for an investor or potential investor."[6]

Notably, a distinction must be drawn between:

(i) providing advice – as stated in the Supervisory Briefing: "A recommendation requires an element of implicit or explicit suggestion on the part of the adviser. In effect, advice involves a recommendation as to a course of action, which may be, or is, presented to be in the interest of the client."; and

(ii) simply providing information – as stated in the Supervisory Briefing: "Information, on the other hand, involves statements of fact or figures. In general terms, simply giving objective information without making any comment, value judgement, or suggestion on its relevance to decisions which an investor may make, is not a recommendation."

The provision of information, while taking it outside the scope of investment advice, however, may also raise the question as to whether that could be construed as constituting "investment research".

It should be noted that a recommendation may be made (a) on the initiative of the firm or (b) of the investor. The fact that a recommendation is being given does not have to be made explicit to the investor – and the investor does not have to act upon the recommendation – for it to be regarded as a recommendation.

The above is important to consider in the context of the ESMA Supervisory Briefing's content and whether the "five key tests" are satisfied or not.

ESMA's Supervisory Briefing's scope and a (revisited) focus on the "five key tests"

ESMA notes that the Supervisory Briefing covers the following aspects:

1. The provision of personal recommendations and whether other forms of presenting information such as "investment research", filtering, general recommendations, generic advice, presenting multiple products or access to model investment portfolios could constitute investment advice.

2. The presentation of a recommendation as "suitable" for a client or based on the client's circumstances, including making recommendations to become a client of a particular firm, making recommendations which are clearly unsuitable in light of knowledge about the client, definitions of a "person's circumstances" and when recommendations will be viewed as based on a view of a person's circumstances.

[5] Notably see Commission Delegated Regulation (EU) 2017/565 available here.

[6] Please note that para. 25 of the ESMA's Supervisory Briefing (as at the time of writing hereof) incorrectly refers to "personal investor" in the last two words as opposed to what is set out in law i.e., "potential investor".

3. Perimeter issues around the definition of personal recommendation, including disclaimers to the client and failing to use known client information in an attempt to try avoiding the qualification as investment advice.

4. Issues around the form of communication, including whether the internet or apps are always a "distribution channel", use of social media posts, messages to multiple clients, distinguishing corporate finance and investment advice and whether these are mutually exclusive.

Given that the core definition of investment advice has not substantially changed under MiFID II, CESR's five Key Tests remain unchanged however ESMA's Supervisory Briefing provides a host of welcome clarifications and practical examples.

In short, all five of the five key tests must be met in order for an activity to qualify as investment advice. These include:

Is it investment advice? (if answer is yes, move to the next question)	**Issues for regulated firms to consider**	**Relevant chapter in ESMA Supervisory Briefing**	**PwC Legal's observations**
1. Does the service being offered constitute a recommendation?	• The difference between information and a recommendation; • Whether assisting a client to filter information amounts to a recommendation;	3.1	• Whether the advice is provided on an independent basis or not, does not affect the application of the definition. • Investor perception matters. ESMA considers a recommendation investment advice if a reasonable observer would think it based on a client's circumstances or suitable, provided the other four tests are met. • ESMA refers to a recommendation as an "implicit or explicit suggestion" i.e., what CESR called an "opinion," emphasising that a recommendation can be implied as well.
2. Is the recommendation in relation to one or more transactions in financial instruments?	• How to distinguish generic advice and general recommendations from investment advice; • Whether recommending a firm or service can amount to investment advice;	3.2	• ESMA emphasises that a client-facing automated or semi-automated system (including interactive software like robo-advice) can be viewed constituting advisery activity.[7] • ESMA considers copy trading may (i) qualify as investment advice if certain conditions are fulfilled and/or (ii) it may also qualify as discretionary investment management if other conditions are fulfilled. ESMA has also published further guidance on copy trading services.[8]
3. Is the recommendation at least one of the following: a. Presented as suitable? b. Based on a consideration of the person's circumstances?	• How a financial instrument might implicitly be presented as suitable; • The impact of disclaimers;	3.3-3.4	• Disclaimers declaring that no investment advice is given or restricting the firm's duty will **not** affect the regulatory consideration on classification of whether the investment advice is provided to clients.

[7] See also definition of "investment advice of an ongoing nature" in the IFR which "…means the recurring provision of investment advice as well as the continuous or periodic assessment and monitoring or review of a client portfolio of financial instruments, including of the investments undertaken by the client on the basis of a contractual arrangement."

[8] See coverage from our EU RegCORE available here.

	• What it means to consider a person's circumstances;		• Websites, investment apps, and social media (including finfluencers) can provide personal recommendations. ESMA has also published further guidance on finfluencers.[9] • Firms offering online investment in a limited number of funds can, in keeping with ESMA's expectations, avoid giving unwanted investment advice by: (1) making sure, during onboarding, the client understands the consequences of not receiving investment advice in terms of investor protection, (2) ranking the funds neutrally (for example, alphabetically), and (3) making clear the client must make his own decision. Investor-information based on whether funds are suitable may be investment advice. • Firms that allow online investing in many funds can, in keeping with ESMA's expectations, avoid giving unwanted investment advice by: (1) ranking the funds neutrally, (2) using filters only for objective characteristics selected by clients, and (3) not steering in which criteria to apply.
4. Is the recommendation issued otherwise than exclusively to the public? – It should be noted that a recommendation shall not be considered a personal recommendation if it is issued to the public.	• Assessing recommendations delivered via the Internet; • Assessing recommendations given to multiple clients at once; • Distributing investment research;	3.5	
5. Is the recommendation made to a person in his capacity as one of the following: a. An investor or potential investor? b. An agent for an investor or potential investor?	• Identifying investors and their agents; and • The distinction between corporate finance advice and investment advice.	3.6-3.7	• ESMA has provided clarity on whether conduct may lead to a categorisation as investment advice (triggering licensable activity) or otherwise fall into the ancillary service of corporate finance advice (not MiFIR/MiFID II regulated activity unless combined with other licensable activity) as well as how to assess situations where there is a "service overlap". Although not conclusive, the "primary purpose test" (see next section below) used to identify the two is nevertheless useful.
If satisfied - treat as Investment Advice			

Distinguishing the ancillary service of corporate finance advice

Under EU rules, while investment advice is a regulated investment service that requires, where conducted on a professional basis, authorisation as an investment firm, the provision of "corporate finance advice" is an "ancillary service" for which EU rules do not require an authorisation in its own right. A firm conducting solely corporate finance advice as an ancillary service will not be able to apply for appropriate authorisation to

[9] See coverage also from our EU RegCORE available here.

conduct such MiFIR/MiFID II activity.[10] Without such authorisation, such firms cannot make use of MiFIR/MiFID II passporting rights and may have to rely on other structural and contractual solutions to conduct regulated activity on a cross-border basis across the EU.

In its full description, the term "corporate finance advice" is set out in Section B(3) Annex I of MiFID II as the provision of "advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings."

Where corporate finance advice is provided by an investment firm (as for any other ancillary service) such firm is only subject, as appropriate, to certain conduct of business obligations under Art. 24 MiFID II. Nevertheless, a fine line exists between when activity is investment advice or corporate finance advice. Para. 100 of the Supervisory Briefing aims to shed light on this by stating (our emphasis in bold and italics):

> "Where the ***client's primary purpose for seeking advice is to generate a financial return on an investment or to hedge a risk***, the client's objective is patrimonial in nature and ***the advice provided would be investment advice***. Moreover, it is important to assess the scope of the investment advice the client expects from the firm. Conversely, ***where the client's primary purpose for requesting the advice is for an industrial, strategic or entrepreneurial purpose*** (i.e., a company wants to buy shares of another company because it wants to take over its assets or expand its production to include new branches) rather than to receive a financial return or hedge a risk, ***the advice provided would be corporate finance advice***. The context relative to the request for advice may be used to determine the primary purpose for the request."

Para. 101 goes on to state (slight typo correction in ESMA's text set out in bold and underline):

> "In situations where it is impossible to identify the primary purpose because both a patrimonial and a strategic/industrial/entrepreneurial purpose are present as well as the firm's scope of activities covers both types of services and neither purpose outweighs the other in importance, ESMA understands that the client would receive investment advice, perhaps simultaneously with corporate finance advice. This is notwithstanding the situations where a firm (such as a law firm or accounting firm) is providing investment advice in an incidental manner in the course of another professional activity not covered by MiFID II provided that this activity is regulated and/or the provision of the advice is not remunerated, in accordance with Articles 2(1)(c) and (k) of MiFID II. However, such entities may act within the capacity of corporate finance adviser without the abovementioned restrictions because it constitutes the ancillary activity referred to in Section B(3) of Annex I to MiFID II."

As a result, in cases of a "service overlap", the regulatory presumption is that the conduct would be considered investment advice as opposed to corporate finance advice. The Supervisory Briefing's clarification is thus reiterated by ESMA in a much more determined and clear manner than in previous commentary on this point.

Moreover, paras. 102 and 103 are clear that:

> "When an undertaking approaches a firm for advice, through an individual authorised to act on behalf of the undertaking, for instance the Chief Executive Officer or the Chief Finance Officer, for the purpose of capital raising, a merger or acquisition, the disposal of a subsidiary or a management buyout, the advice provided to the client will fall under the corporate finance advice category, because the primary purpose of soliciting the advice relates to the present or future strategy of the undertaking.
>
> In the context of private equity and venture capital, the industrial purpose of the firms providing these services is purely financial. Where individuals authorised to act on behalf of these firms seek advice, their primary objective is likely to be mainly entrepreneurial, and also aligned to the industrial purpose of the private equity or venture capital firms i.e., to generate a return and the scope of firm's activity is different from the typical investment advice activity. That is why, where such clients seek advice in this context, ESMA considers it to be corporate finance advice."

The clarifications offered in paras. 102 and 103 are certainly welcome for a number of affected firms seeking services from their service providers. What should be noted is that the reference to "undertaking" in para. 102 means a non-financial corporate but may include also a regulated financial services firm in respect of their corporate finance activity. Equally, the reference to: "for instance the Chief Executive Officer or the Chief

[10] It should be noted that a number of domestic legislative regimes of EU Member States' (including the UK while it was part of the EU) contain or contained, prior to the advent of the MiFID I regime, definitions of "corporate finance business" or "corporate finance contact". These or conceptually similar definitions typically clarify what constitutes that type of business and how MiFID I rules, as amended since then, apply, if at all to the activity and/or the treatment and regulatory classification as a client or not. While ESMA's clarifications are welcome, they should be viewed in the context of any jurisdictional specifics and residual considerations that may apply to a given relationship between firm and recipient of the corporate finance advice.

Finance Officer" should not be read as precluding any persons or deal teams that are suitably empowered to act.

In view of the above, certain M&A and corporate finance firms (in particular those that are not regulated at all) might want to assess whether there are changes that need to be made to their internal policies and procedures to ensure they can remain operating solely under the standards applicable to corporate finance advice and not stray into investment advice. Accordingly, certain firms may also want to consider reviewing terms in their existing and new client-facing and other legal documentation to ensure communication is suitably clear on the points raised by ESMA. As ESMA has indicated, disclaimers will unlikely be sufficient in their own right. As a result, some firms may wish to also evaluate whether respective recipients of corporate finance advice should equally actively acknowledge in writing the extent and regulatory categorisation of what they are receiving plus confirm their understanding of what aspects of the MiFIR/MiFID II regime apply to them and/or which do not.

Outlook and next steps

ESMA's Supervisory Briefing is certainly sensible and should be welcomed by financial services firms when reviewing how they currently provide and equally document respective activity. ESMA and the NCAs have already communicated that they will continue to apply close scrutiny of how firms are meeting applicable standards. This is likely to increase even further in the event that new clarifications, guidance or changes proposed by the EU's Retail Investment Strategy package of reforms alter (i) thresholds as to how, and at what level, a client is treated as a retail client or a professional client as well as (ii) set common standards of competence and qualifications that professionals providing investment advice should evidence.

Equally, corporate finance advisers will want to ensure that their business model continues to remain classified as an ancillary service and thus not stray over into investment advice. Nevertheless, it is very conceivable that ESMA and NCAs will, over the next supervisory cycles, begin to direct greater interest in how corporate finance advisers provide their services (including to institutional clients and where a service overlap could exist) and how this meets current supervisory expectations. A general policymaking option remains on the table of legislative and regulatory rulemakers to bring (non-regulated) corporate finance advisers into a much closer level of supervision than is currently the case across the EU-27.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from relevant related developments. We have assembled a multi-disciplinary and multijurisdictional team of sector experts to support clients navigate challenges and seize opportunities as well as to proactively engage with their market stakeholders and regulators.

Moreover, we have developed a number of RegTech and SupTech tools for supervised firms, including PwC Legal's Rule Scanner tool, backed by a trusted set of managed solutions from PwC Legal Business Solutions, allowing for horizon scanning and risk mapping of all legislative and regulatory developments as well as sanctions and fines from more than 750 legislative and regulatory policymakers and other industry voices in over 170 jurisdictions impacting financial services firms and their business.

Moreover, in leveraging our Rule Scanner technology, we offer a further solution for clients to digitise financial services firms' relevant internal policies and procedures, create a comprehensive documentation inventory with an established documentation hierarchy and embedded glossary that has version control over a defined backward plus forward looking timeline to be able to ensure changes in one policy are carried through over to other policy and procedure documents, critical path dependencies are mapped and legislative and regulatory developments are flagged where these may require actions to be taken in such policies and procedures.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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