RegCORE Client Alert

Financial Services: ESMA publishes final Guidelines on appropriateness and execution-only requirements under MiFID II

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Financial Services

ESMA publishes final Guidelines on appropriateness and execution-only requirements under MiFID II

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QuickTake

On 3 January 2022 the European Securities and Markets Authority (**ESMA**) published its Final Report on "Guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements" (the **2022 Guidelines**).[1] The purpose of the 2022 Guidelines is to enhance clarity and to foster convergence of the appropriateness and execution-only requirements in the EU's MiFIR/MiFID II legislative and regulatory regime as well as how national competent authorities (**NCA**s) supervise financial services firms' compliance.

Under the EU's MiFIR/MiFID II rules firms providing 'non-advised services' are required to request information on the knowledge and experience of clients or potential clients to assess whether the investment service or product envisaged is appropriate, and to issue a warning in case the investment service or product is deemed inappropriate. The execution-only framework allows for an exemption to this assessment in certain conditions, including that the firm issues a warning to the client.

The publication by ESMA of the 2022 Guidelines closes the chapter on a workstream that started on 3 June 2019[2] in which ESMA first used a new tool, a common supervisory action (**CSA**), across the EU-27 with a view to driving convergence on rules, their interpretation and how NCAs monitor compliance by relevant firms. CSAs, when introduced, marked a shift in ESMA's approach and supervisory scrutiny well beyond what firms

[1] Available here but which should also be read in conjunction with an earlier "Supervisory Briefing" from April 2019 (available here) from ESMA on the same subject, even if issued in the context of wider-reaching guidelines on suitability from May 2018 an area that itself was subject to a CSA in 2020. Technically the 2019 Supervisory Briefing still remains valid and in force even if it has not been updated to cross-refer to the 2022 Guidelines to which it is of course subsidiary in the rulemaking hierarchy. Moreover, firms will want to also read this Client Alert in conjunction with other coverage (available from our EU RegCORE Thought Leadership section) on ESMA's CSA, notably on its CSA on MiFID II Suitability Rules that was launched 5 February 2020 which concluded with publication of results on 21 July 2021 and the final Guidelines on the topic.

[2] See announcement here.

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may have experienced in national led thematic reviews and/or action targeting specific firms (or indeed NCAs).

The 2019 CSA's results evidenced there was much need for convergence in the area of appropriateness and execution-only activities of firms. A public consultation on the draft of the 2022 Guidelines took place in January 2021.[3] Consequently, the final 2022 Guidelines further refine and harmonise principles on several important points in the appropriateness process, spanning from the information disclosed to clients about the purpose of the appropriateness assessment, the arrangements necessary to understand clients and products, as well as the matching of clients with appropriate products and the effectiveness of warnings. The 2022 Guidelines further clarify the execution-only exemption and record-keeping and controls.

The final 2022 Guidelines are now set to be translated into the official languages of the EU and published on ESMA's website and concurrently trigger a two-month period in which NCAs must confirm to ESMA whether they will comply with the 2022 Guidelines (there is an expectation that most NCAs will) or not. The final 2022 Guidelines will apply six months following the date of their publication on ESMA's website in all EU official languages.

This Client Alert provides a recap on the relevant MiFID II requirements that were assessed as part of the CSA, the findings ESMA published following completion of its 2019 CSA and an overview of the new 2022 Guidelines and the impact on affected financial services firms. In summary, relevant financial services firms will want to be prepared to respond to questions from NCAs and equally implement, where necessary, targeted changes to the selling practices of financial instruments in the EU-27.

Background to the relevant MiFID II requirements in scope of the 2019 and 2020 CSA

Since 3 January 2018, the EU's revised Markets in Financial Instruments Directive 2014/65/EU of (**MiFID II**) and its complementary Regulation (**MiFIR**) have been the key set of conduct of business rules concerning transactions in financial instruments as well as, amongst other things, investor protection rules. MiFID II distinguishes between advised sales, non-advised sales and execution only transactions. When providing investment services, notably advice to clients (i.e., an advised sale), a firm has to assess whether the MIFID financial instruments or investment service(s) it provides to the client are "suitable" for such client. Suitability means that that such instrument or service:

i. meets the investment objectives of the client in question, including the client's risk tolerance levels;

ii. is such that the client is able financially to bear any related investment risks consistent with his investment objectives; and

iii. is such that the client has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of the client's portfolio.

In the event that a firm concludes that the investment service, product or financial instrument is deemed inappropriate the firm has to issue the client with a warning to that effect.

If neither investment advice nor financial portfolio services are provided, the firm will only have to assess whether the financial instruments or service it offers to its client are appropriate for such client. In such instances the appropriateness test only requires that the third of the abovementioned items i.e., the client's experience and understanding is completed and documented.[4]

The rules in the MiFIR/MiFID II framework however do permit financial services firms to sell a financial instrument to a client without having assessed the appropriateness for that client. Such sales are referred to as "execution only" sales and are only permitted in the case of non-advised sales that relate to "non-complex" financial instruments. Such "non-complex" instruments include: (a) shares and bonds admitted to trading venues in the EU, (b) money market instruments and (c) shares in non-structured UCITS funds. If a firm is conducting such an execution-only sale then the firm is required to warn the client that it is not required to conduct an appropriateness assessment and thus that the client will not benefit from corresponding investor protection.

Given that the rules on suitability and appropriateness are mostly set out in MiFID II, i.e., an EU Directive, these rules had to be implemented by each EU Member State into "their" own domestic frameworks. Divergences have followed, especially as Member States, in implementing MiFID II, were permitted to make

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[3] See further details here. The consultation closed 29 April 2021 and ESMA received 33 responses of which 5 were confidential. ESMA also received advice from its "Securities and Markets Stakeholders Group". The public responses are available on the ESMA website.

[4] As set out in Art. 56(1) of Delegated Regulation (EU) 2017/565).

use of national options and discretions. Equally, the supervision of MiFID II (on these rules and generally) may, despite supervisory convergence efforts by ESMA, differ between NCAs. ESMA's 2019 CSA and the 2022 Guidelines seek to

As a directive, MiFID II had to be implemented into the domestic law of each EU Member State. In implementing MiFID II and in supervising its application, member states have a certain degree of discretion. Thus, the legal implementation and the supervision of MiFID II by the competent NCAs may vary between Member States.

ESMA's 2019 CSA and its findings

ESMA is mandated to take an active role in building a common supervisory culture among NCAs to promote sound, efficient, and consistent supervision throughout the EU. ESMA's promotion of supervisory convergence is done in close cooperation with NCAs. Such a common supervisory culture serves to strengthen the operation of the EU's Single Rulebook and thus the Single Market for financial services more generally. In the 2019 CSA, ESMA specifically asked NCAs how they supervise how financial services firms comply with the requirements relating to appropriateness tests and execution-only sales under MiFID II.

The 24 NCAs that participated in the 2019 NCA simultaneously carried out a review based on a sample of firms under their supervision. For such review, ESMA employed a common methodology including a list of questions that were taken from ESMA's 2019 Supervisory Briefing.[5] ESMA's questions[6] therefore focused on:

1. determining when an appropriateness assessment is needed;
2. categorisation of financial instruments for the purpose of the appropriateness assessment;
3. obtaining information form clients on their knowledge and experience;
4. assessment of appropriateness;
5. statistics; and
6. warnings to clients.

Unsurprisingly, ESMA concluded (see para. 16 of the Final Report) that "…this CSA showed there was a need for further convergence in the understanding and application of several areas of the appropriateness and execution only requirements by firms in different Member States, and often within Member States themselves, creating problems for achieving a consistent level of investor protection in the EU. Therefore, ESMA decided to develop guidelines [i.e., the 2022 Guidelines] to enhance clarity and foster convergence in the application of certain aspects of the appropriateness and execution only requirements."

The findings to the 2019 CSA are set out in the Final Report in which the 2022 Guidelines are published. This Final Report, in Annex IV, also summarises the responses to the consultation process that was conducted in 2021 and which fed into the final 2022 Guidelines. ESMA welcomed that most respondents were positive for ESMA's initiative to conduct a CSA in this area and the workstreams leading to the 2022 Guidelines along with a need to retain a distinction (conceptually as well as to compliance obligations) between the MiFID II rules on "suitability" and the 2019 CSA's focus on the MiFID appropriateness regime and ultimately the 2022 Guidelines.

Key takeaways from the 2022 Guidelines

Ahead of their publication on the ESMA website, the 2022 Guidelines are contained in Annex VI of the Final Report (from page 36 onwards).[7] The 2022 Guidelines apply to NCAs and supervised firms. As explained above, NCAs have an obligation to confirm whether they will comply with the 2022 Guidelines (a separate compliance table will follow) in line with the procedure described above.

There is an expectation that all NCAs will comply in particular since para. 6 of the 2022 Guidelines, cross-referencing Art. 16(3) of the ESMA Regulation (i.e., its founding document) states that NCAs and financial market participants "…must make every effort to comply with these guidelines".

ESMA sets out its supervisory expectations across 13 individual Guidelines (which should be read collectively as many cross-refer to one another) – these can be summarised as follows:

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5 Available here but also see context explained in Footnote 1 above.
6 A full list of which is set out in Annex 1 to the Final Report (for ease refer to page 10 here).
7 For ease of reference available here

- **Guideline 1**: Firms should, in good time before the provision of non-advised services (in the case on an ongoing relationship before the initial service is provided and whenever the client is requested to update their level of knowledge and experience – usually annually), inform their clients, by using clear and simple language, about the appropriateness assessment and its purpose which is to enable the firm to act in the client's best interest. Firms are reminded that they should avoid stating or giving misleading impressions that it is the client who decides on the appropriateness of the investment service or product or who establishes which investment service or product fits their own knowledge and experience.[8]
- **Guideline 2:** Firms' policies and procedures (as well as tools and questionnaires with clear questions related to actual scenarios) "should" (read must) aim to enable firms to collect all information necessary to conduct the appropriateness assessment in relation to the specific product types offered by the firm or demanded by the client. In keeping with the above, such policies and procedures should not dissuade clients from providing information and/or permit/encourage them to overestimate[9] their knowledge and experience or allow for circumvention of providing answers.[10] The contents of this Guideline and the accompanying clarifications on supervisory expectations are much more prescriptive than in previous material published by ESMA on the outcomes firms need to evidence they are complying with.
- **Guideline 3:** Firms should take into account the type and characteristics of the investment products or services to be considered (i.e., the level of complexity and risk of the investment products or services) and the nature of the client. In the context of bundled services, the firm must consider whether the overall bundled package is appropriate both in relation to the investment products but also the other (including ancillary) services that are being offered.
- **Guideline 4:** Firms should take reasonable steps and have appropriate tools to ensure that the information provided by clients is reasonable and consistent without unduly placing reliance on the clients' self-assessment. This includes firms taking reasonable checks (usually by way of follow-up questions or profiling software) as to the reliability, accuracy and consistency of information collected about clients and not merely the fact that clients are expected to provide correct, up-to-date and complete information. Firms are expected to ensure that such-follow up questions or use of profiling software are fit for purpose and include consistency controls on the replies provided by clients as well as all information provided as a whole.
- **Guideline 5:** When firms rely on previously collected information on clients' knowledge and experience, firms should establish procedures defining the frequency of updating such information in order to ensure that the information remains up to date and is accurate and complete for the purpose of the appropriateness assessment. Specifically, ESMA recognises that the frequency for updating information on clients under the appropriateness regime will likely be lower than under the suitability regime. Firms are reminded on the need to develop their policies in such a manner that sets an appropriate frequency

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[8] ESMA provides further clarifications concerning this Guidelines. These set out that the firm should provide information to the client that:

- It is the firm's responsibility to conduct the assessment and do so in a manner that the client understands the reason why it is being asked to provide up-to-date, accurate and complete information and it is in the best interests of the client to provide such information;
- The situations in which no assessment will be done (incl. where the client does not provide the requested information ***or*** where the services are provided under an execution-only basis) and do so in a manner that does not give the client the impression that the default scenario is not to provide such information; and
- A short explanation (in a non-confusing manner) on the differences between advised and non-advised investment services.

[9] ESMA specifically in para. 25 on page 42 of the Final Report provides two examples in how a self-assessment ought to be counterbalanced by objective criteria. These include:

1. Instead of asking whether a client understands the notions of risk-return trade-off of specific types of investment products, the firm should for instance question clients on some practical examples of situations that may occur in practice, for example by means of graphs or through positive and negative scenarios which are based on reasonable assumptions; and
2. Instead of asking a client whether s/he has sufficient knowledge about the main characteristics and risks of specific types of investment products, the firm should for instance ask questions aimed at assessing the client's real knowledge about the specific types of investment products, for example by asking the client multiple choice questions to which the client should provide the right answer;

[10] Specifically, ESMA (in para. 22 on page 41 of the Final Report) states that firms "… could: consider limiting the number of times clients can answer the questionnaire(s) within a certain period of time, work with different sets of questionnaires when a client requests to retake the questionnaire and/or use a cooling-off period. Where such measures are imposed (notably there is no strict legal requirement in MiFID II that prescribes a cooling-off period), a client could still be allowed to proceed with the transaction, provided that a warning is issued in case of transactions in relation to which the client does not have sufficient knowledge and experience. Firms could also implement other controls to ensure that a client cannot repeat the questionnaire several times to "test" what kind of answers are needed to get the desired outcome."

for when to collect updated information and that such frequency should be higher in respect of those that are deemed to be "vulnerable clients".[11]

- **Guideline 6:** Firms should have a policy defining on an ex-ante basis how to conduct the appropriateness assessment in situations 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. Such a policy should be drafted in accordance with the general guideline 6 and supporting guidelines enshrined in "ESMA Guidelines on certain aspects of the MiFID II suitability requirements". Crucially, firms will want to consider on making clear distinction where a representative is foreseen under applicable national law or where a client is permitted to designate such a representative. In such instances, firms will want to have set steps that clarify how this may affect existing appropriateness assessments along with an assessment to be conducted in respect of that representative.
- **Guideline 7:** Firms should ensure that policies and procedures are implemented to understand the characteristics, nature, and features of investment products in order to allow them to assess if such products are appropriate to their clients. Reliable and objective procedures and tools should be used by the firm to consider the different characteristics and relevant risk factors (such as credit risk, market risk, liquidity risk) of the investment products offered or demanded. This should include taking into consideration the firm's analysis conducted for the purposes of product governance obligations. In this context, firms should carefully assess how certain investment products could behave under different circumstances (e.g., convertible bonds which may, for example, change their nature into shares).[12]
- **Guideline 8:** Firms' policies and procedures employed to match an investment service or product as being appropriate to a client should consistently take into account (i) all information obtained about the client's knowledge and experience necessary to assess whether an investment product is appropriate; and (ii) all relevant characteristics and risks of the investment products considered in the appropriateness assessment. Firms must act upon policies and procedures and issue a clear and not misleading warning in case they consider that the investment service or product is not appropriate for the (potential) client.
- **Guideline 9:** Firms must ensure that warning issued by it are prominent, clear and not-misleading in that the investment services or product offered or demanded is deemed to be appropriate for that client and correctly received and understood by the client. Firms are encouraged to clarify why a particular conclusion has been reached and should avoid using ambiguous and/or imprecise wording but at the same time avoid overly long warnings that obscure the key message. Firms are also reminded that they should not downplay the importance of warnings or encourage clients to ignore them or otherwise encourage them to either re-take the assessment or otherwise to request an upgrade to "professional client" status – which would alleviate some of the rules requiring an assessment. Firms are encouraged to implement a process that the client confirms their awareness of the contents of the warning before they can proceed further.

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[11] It is important to note that across the EU there are no set defined criteria as to which types of natural persons (but in theory also corporates such as SMEs) are "vulnerable clients" but these are generally taken to mean older clients, those that are incapacitated or otherwise facing some form of hardship. Accordingly, in the (current) absence of a harmonised definition and thus uniform rules, firms will want to ensure that where they do (or indeed should have) a policy on vulnerable clients that this works across multiple jurisdictions.

[12] ESMA also clarifies that:

- Considering the level of 'complexity' of products is particularly important, and this should be matched with the client's information on knowledge and experience. Although complexity is a relative term, which depends on several factors, firms should – further to the assessment of products as complex or non-complex as required for the distinction between services that require an appropriateness assessment and those that do not - also take into account the criteria and principles identified in MiFID II, when defining and appropriately graduating the level of complexity to be attributed to investment products for the purposes of the appropriateness assessment.
- Firms should adopt procedures to ensure that the information used to correctly classify investment products included in their product offer is sufficiently reliable, accurate, consistent, and up to date. Such procedures should take into account the different characteristics and nature of the investment products considered. In addition, firms should review the information used so as to be able to reflect any relevant changes that may impact the investment product's classification. This is particularly important taking into account the continuing evolution and growing speed of financial markets.
- When categorising investment products for the purpose of the appropriateness assessment, firms should use a sufficient level of granularity to ensure that only investment products with sufficiently comparable characteristics and risk features are grouped together and client's experience and knowledge is being assessed on such characteristics and risks. Firms should consider multiple key factors for the categorisation (such as, for instance, optionality elements (in case of derivatives, or products with embedded derivatives); financial leverage; eligibility to bail-in; subordination clauses; observability of the underlying (e.g. the use of unfamiliar or opaque indices); guarantees of principal repayment or capital protection clauses; liquidity of the product (i.e. tradability on trading venues, bid-ask spread, selling restrictions, exit charges); and the currency denomination of the investment product).

- **Guideline 10:** A firm's staff involved in the appropriateness assessment should evidence that they understand the role they play in this assessment and have an adequate level of skills, knowledge, and expertise, including sufficient knowledge of the relevant regulatory requirements and procedures in order to discharge their responsibilities. Firms should regularly train their staff.
- **Guideline 11:** Firms should, as a minimum, ensure that they (i) maintain adequate recording and retention arrangements to ensure orderly and transparent record-keeping regarding the appropriateness assessment, including the collection of information from the client and the non-advised service provided; (ii) ensure that record-keeping arrangements are designed to enable the detection of failures regarding the appropriateness assessment; (iii) ensure that records kept are accessible for the relevant persons in the firm and for competent authorities; and (iv) have adequate processes to mitigate any shortcomings or limitations of the record-keeping arrangements.
- **Guideline 12:** Firms should adopt appropriate arrangements to ensure that they are able to determine situations where an appropriateness assessment needs to be performed and avoid performing one in situations where a suitability assessment needs to be performed.
- **Guideline 13:** Firms should have appropriate monitoring arrangements and controls in place to ensure compliance with the appropriateness requirements. Firms must ensure that their automated systems, tools and controls are fit for purpose and monitored periodically. Firms are expected to keep records of such monitoring.

As a further general overarching principle, but specifically in respect of Guideline 1, ESMA expects that all information provided to clients complies with relevant provisions set out in MiFID II (including obligations on the provision of information in durable medium[13]). ESMA also states that for firms providing online services, that means to place sufficient emphasis on the relevant feature through pop-up boxes and other design features as well as the use of interactive text (such as tooltips) or additional FAQ sections should be considered and implemented. We would expect that NCAs and indeed ESMA will be proactively monitor compliance with these recommendations set out in the 2022 Guidelines.

Outlook

The outcomes from ESMA's 2019 CSA and now the final 2022 Guidelines are worth taking note of as it will not only require careful consideration of how firms interact with individual NCAs but equally all NCAs. Firms will want to ensure they adopt a pan-jurisdiction and thus pan-authority approach to what is likely to be a much sharper degree of supervisory scrutiny now that ESMA has communicated a comprehensive set of clear supervisory expectations.

Some firms may want to reassess whether existing policies, procedures along with systems and controls meet the outcomes contained in the 2022 Guidelines and either introduce targeted changes or implement new measures where required. Firms should also be prepared to be ready to potentially "explain or defend" files and practices both with respect to individual or groups of NCAs as part of ongoing supervisory engagement but equally ahead of any further CSAs or other form of coordinated supervisory inspections.

[13] Including the ability to print and/or save information submitted.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

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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