



## ESMA Guidelines on certain aspects of the MiFID compliance function requirements and on certain aspects of the MiFID suitability requirements – Publication of Final Reports

While the proposal for a directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast) (“**MiFID II**”) is currently under discussion with the European Parliament, on 6 July 2012, the European Securities and Markets Authority (“**ESMA**”) released two sets of guidelines (final reports), one on certain aspects of the MiFID compliance function requirements<sup>1</sup> and the other one on certain aspects of the MiFID suitability requirements<sup>2</sup> (the “Guidelines”).

### I. Purpose and Scope of the Guidelines

The purpose of the Guidelines, which are composed of general guidelines each further clarified by one or several supporting guidelines, is to clarify the application of certain aspects of the MiFID compliance function (II) and the MiFID suitability requirements (III) in order to promote a common, uniform and consistent application of such requirements within the EU.

Competent authorities to whom Guidelines apply (such as the CSSF in Luxembourg) should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants (*i.e.* banks and investment firms).

They must notify ESMA whether they comply or intend to comply with the Guidelines (with reasons for any non-compliance) within two months of the publication of the translations by ESMA. The Guidelines will start to apply sixty calendar days after said reporting requirement date.

In the following paragraphs you will find a brief overview of some of the key points set out in each of the Guidelines.

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<sup>1</sup> ESMA/2012/388

<sup>2</sup> ESMA/2012/387

## II. Guidelines on certain aspects of the MiFID compliance function (the “Compliance Guidelines”)

The Compliance Guidelines are organised on the basis of three main themes.

### A. Responsibilities of the compliance function

- Compliance risk assessment: The Compliance Guidelines particularly emphasise that the compliance function (and not the firm’s governing body) must regularly perform a compliance risk assessment, on a risk based approach to determine the focus of its monitoring and advisory activities.
- Monitoring obligations: The investment firm must establish a monitoring programme taking into consideration all areas of the firm’s investment services and activities, aiming at evaluating whether the firm’s business is constructed in compliance with MiFID obligations. In case of a group, responsibility for the compliance function rests with each firm of that group.
- Reporting obligations: the banks or investment firms should ensure that regular written compliance reports are sent to senior management at least annually while significant findings should however be reported promptly.
- Advisory obligations: The compliance function must provide support for staff training as well as day-to-day assistance for staff and must participate in the establishment of new policies and procedures; however the business management remains responsible for the training so that the role of the compliance function is limited to advising and supporting the operational function in this area.

### B. Organisational requirements of the compliance function

The Compliance Guidelines particularly stress the following elements:

- Effectiveness of the compliance function: Appropriate human and other resources (such as IT resources) should be allocated and access to all relevant information should be provided to the compliance function whose staff should be regularly trained and have the authority required for their duties including a sufficiently high degree of knowledge (especially of MiFID and relevant ESMA guidelines), experience and personal skills.
- Permanence of the compliance function: The tasks and responsibilities of the compliance function (to be set out in a “compliance policy”) should be performed on an ongoing basis and written arrangements should ensure that the function is adequately fulfilled during any absence of the compliance officer.
- Independence of the compliance function: The compliance function should hold a position in the organisational structure of the firm ensuring its independence as well as its proximity to transactions and its staff should be appointed and replaced by senior management.
- Proportionality exemption: Where a bank or an investment firm intends to rely on the proportionality exemption to reduce the requirements relating to the compliance function, it must record the justifications for the reliance on the proportionality exemption. Where a firm benefits from the proportionality exemption it may inter alia combine the legal and the compliance function.
- Combining the compliance function with internal control functions: The compliance function should not be combined with the audit function. However, ESMA Guidelines emphasise that in certain circumstances, it may be more appropriate to have one person responsible for both functions – to the extent that each function’s responsibilities are discharged properly. This should be discussed with the supervisory authority.

Combination of the compliance function with other control functions (to be documented), may be acceptable as long as no conflicts of interest are generated and the compliance function's effectiveness or independence is not compromised.

- Outsourcing of the compliance function: The MiFID outsourcing requirements for critical or important functions apply to the outsourcing of the compliance function. Banks or investment firms are expected to undertake a due diligence assessment of the service provider and monitor whether the service provider performs its duty adequately. Any outsourcing of the compliance function within a group does not lead to a lower level of responsibility for the senior management of the bank or the investment firm.

### **C. Competent authority review of the compliance function**

Competent authorities should review, during the authorisation process and in the course of the ongoing supervision, how firms plan to apply/apply the MiFID compliance function requirements.

## **III. Guidelines on certain aspects of the MiFID suitability requirements (“Guidelines on Suitability Test”)**

The Guidelines on Suitability Test provide interesting but very strict and constraining clarifications on several practical issues that market participants face.

### **A. Investment firms should inform the clients about the suitability assessment (guideline 1)**

Pursuant to ESMA guidelines, banks or investment firms should inform their clients about the suitability assessment and the purpose of such assessment. They should particularly highlight to the client that it is important to gather complete and accurate information.

At no stage should banks or investment firms create any ambiguity or confusion about their own responsibilities in the process. They should particularly avoid requiring the client to confirm that an instrument is suitable (or indicate to the client that a certain financial instrument is the one that the client chose as being suitable). The suitability assessment is the responsibility of the bank or investment firm.

Investment firms should in addition take steps to ensure that the client understands the notion of investment risk as well as the relationship between risk and return on investments.

### **B. Investment firms should have in place an adequate organisation (guidelines 2 and 3)**

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 they are offering.

Thus, staff must have the necessary skills to be able to assess the needs and circumstances of the client and have sufficient expertise in financial markets to determine whether the features of a financial instrument match the needs and circumstances of their clients.

Investment firms are in addition required to ensure that staff involved in material aspects of the suitability process have an adequate level of knowledge and expertise to understand the role they play in the suitability assessment process and have sufficient knowledge of the relevant regulatory requirements and procedures.

### C. Scope of information to be collected from the client (guidelines 2, 4, 5 and 6)

- Extent of information to be collected: Banks or 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.

The extent of information collected may vary (proportionality principle) depending on:

- a. the type of financial instruments or transactions that the firm may recommend or enter into (including the complexity, the level of risk, whether the instruments are liquid or illiquid);
- b. the nature and extent of the service that the firm may provide:
  - 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.
  - On the other hand, when portfolio management services are to be provided, sufficient information should be collected to ensure that the client at least understands 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.
- c. The nature, needs and circumstances of the client<sup>3</sup>: 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. More in-depth information would also usually need to be collected for elder and potentially vulnerable clients asking for investment advice services for the first time.

In any case, information necessary to conduct a suitability assessment should include marital status, family situation, employment situation, client's age.

- Client self-assessment: ESMA particularly stresses those firms should take reasonable steps to ensure that the information collected about clients is reliable and they should not rely unduly on clients' self-assessment. The way questions are asked to the client (for example in the risk profile) is of particular importance in this respect.
- Updating of client information: current market practice is that client information updating remains mainly at the discretion of firms. However, ESMA's Guidelines on Suitability Test emphasize that firms should establish appropriate procedures in order to maintain adequate and updated information about the client. Such procedures should define what information should be subject to updating, how the updating should be done and at which frequency.

### D. Suitability of an investment and record-keeping obligation (guidelines 7,8 and 9)

ESMA also provides in its supporting guidelines for certain arrangements that investment firms should comply with when carrying out a suitability test.

- ESMA specifies that a firm should establish policies and procedures which enable to ensure inter alia that the client can finance the investments and the client can bear any possible losses resulting from the investments.

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<sup>3</sup> Interestingly enough, ESMA indicates in its Guidelines that "where a firm provides investment advice or portfolio management services to a professional client, it is **generally** entitled to assume that the client has the necessary level of experience and knowledge" whereas MiFID provisions are less nuanced: "Where an investment firm provides an investment service to a professional client it **shall be** entitled to assume that (...) the client has the necessary level of experience and knowledge." (Article 36 of the directive 2006/73/EC)

- ESMA also deals with the question “who should be subject to the suitability assessment?” where the client is a group of two or more natural persons or where one or more natural persons are represented by another natural person.

According to ESMA the firm, based on a predefined policy, should agree with the relevant persons as to who should be subject to the suitability assessment and how this assessment will be done in practice. The investment firm should make a record of the agreement. Where there is no agreement, the firm should consider the most relevant person in this respect, i.e. as regards financial situation, the person with the weakest financial situation, as regards investment objectives, the person with the most conservative investment objectives, and as regards experience and knowledge, the person authorised to carry out transactions with the least experience and knowledge.

ESMA confirms that where a natural person is represented by another natural person, the financial situation and investment objectives should be those of the underlying client, whilst the experience and knowledge should be those of the representative of the natural person.

- ESMA Guidelines on Suitability Test specifically emphasize that record-keeping arrangements adopted by investment firms must be designed to enable firms to track ex-post why an investment was made – for control purposes and in the event of a dispute between a client and the firm.

Therefore, an investment firm is required to record all relevant information about the suitability assessment (such as information about the client, about the financial instruments, etc.).

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