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MiFID II: Suitability and Appropriateness

Practical guidelines for
investment services



Preface

It gives me great pleasure to write this foreword to this white paper by Ronald Janssen, Arthur Kilian and Tom Loonen. It deals with suitability and appropriateness for investment professionals with private clients. These are key aspects of MiFID 2, which is going to be applicable from 2018 onwards.

In preparation for the introduction of MiFID 2, a more detailed exploration of these issues is extremely desirable.

The three authors work in the field and, as such, are specialists, albeit from different perspectives. They have succeeded in presenting the important aspects of suitability and appropriateness in a way which is accessible to the reader. As far as I am concerned, this combining of knowledge and practical experience makes the white paper compulsory reading for all professionals involved in investment services.

The importance of clear legislation and regulations in the field of investment services provided to private individuals is evident. In recent years regulators have been issuing more and more regulations and guidelines and, more often than not, these are complex and abstract. For that reason, clarifying papers like this one are a godsend.

Why?

The new MiFID 2 rules are, in the first instance, important for the continued protection of non-professional investors. The numerous past examples of 'mis-selling' are evidence of how important it is to provide proper protection for this group. Even after the introduction of MiFID 2 this will continue to be a topical issue.

The regulations dealt with in this paper are intended to provide even better help to clients. This can only truly be the case if the client's specific situation is carefully analysed. In this way the right investment solution can be found for the client in question.

Clear guidelines on how to specify suitability and appropriateness are also important from a perspective other than the investing consumer, namely that of the professional in the field. The focus is then on the investment advisers and asset managers involved in the provision of services to private individuals.

More than rules

It will take more than the drawing up and imposition of European regulations to ensure the success of the promotion of good professional practice by investment professionals.

What is important is to actually improve the tools professionals have to ensure that they can do their work properly. It is essential that they have up-to-date knowledge and skills to enable them to retrieve the client information that really matters.

I believe that the investment sector and the people who work in it will also benefit from the proper application of the MiFID regulations.

As chairman of DSI my task is to stimulate, wherever possible, good professional practice by the professionals who serve investment clients. Stichting DSI promotes integrity and expertise in the context of investment services through personnel screening, certification (permanent education), its own disciplinary rules and a public register.

The further detailing of the elements of suitability and appropriateness will also be explicitly included in future DSI training requirements. Focusing attention on this in lifelong learning will serve to promote good professional practice in the long term. This white paper is a foretaste of that development.

ESMA

In this context I would like to refer to another development which is going to come into effect in 2018.

In December 2015 ESMA published the 'Guidelines for the assessment of knowledge and competence'. These rules are also going to become applicable in 2018 and will make it even more important to provide continuous proof of professional skills in the near future.

This is a welcome development. Organisations and professionals are sometimes slow to respond to new legislation and regulations. As a result there is a risk that they will only find out about the details at the last moment.

The issues in this white paper are too important to suffer the same fate. I am convinced that good cooperation with those in the field is the only way to ensure optimal compliance with, and implementation of, the MiFID 2 regulations. This white paper is a major step in the right direction.

I wish you plenty of inspiration in your preparations for 2018.

Dirk Schoenmaker
DSI Chairman

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1. Introduction

MiFID II/ MiFIR¹ will have to be implemented on 3 January 2018. The aim of MiFID II/ MiFIR is to increase the efficiency and transparency of the European financial markets and enhance protection for investors. This white paper focuses on investor protection and, in particular, on 'suitability' and 'appropriateness' for non-professional investors.

For many market participants, implementing and executing the obligatory assessments, which are an element of suitability and appropriateness, into their company processes in a client-oriented and efficient way is a major challenge.

Investment firms will have to gain an increasingly better insight into the personal (financial) situation of the client², including the client's investment knowledge and experience, wishes and objectives. Providing this insight often requires frequent interaction with the client and the consulting of various systems in order to form a properly substantiated picture. In order to do this in surroundings where systems are often outdated and where the client interaction is fairly product-driven, the building of a picture of the client ('Know Your Customer') in an efficient way against acceptable cost presents a real challenge.

This white paper is intended to facilitate a practical transition and offers guidelines for the proper implementation of MiFID II/ MiFIR. The point of departure is to study the possibilities offered by the MiFID II/ MiFIR framework rather than (only) establishing what is impossible. In addition to this, information and guidelines provided by ESMA, the European Securities and Markets Authority, are also used to clarify or make the transition to implementation of the MiFID II framework.

The target group of this white paper is anyone involved, directly or indirectly, in serving investment clients. Examples are advisers, heads of private and retail banking, product managers, compliance officers, etc.

This document consists of five chapters with chapter 2 defining the framework by describing the most important points of MiFID II/ MiFIR in the field of 'suitability' and 'appropriateness'. Chapters 3 and 4 describe the practical applicability, with a more detailed clarification of specific issues. Chapter 5 contains guidelines as to what investment firms can do now and in the near future to meet the challenges described above.

¹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance. Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

² In this white paper the term 'client' refers to an investor who is classified as a 'non-professional client'. For the sake of completeness we would like to point out that, under MiFID II, suitability applies to professional clients in some situations.

2. Regulatory context

2.1 Introduction

MiFID – the Markets in Financial Instruments Directive – came into effect on 1 November 2007, replacing the Investment Services Directive (ISD). The ISD introduced the European passport for investment firms to offer their investment services within the EU based on the licence granted by the home regulator. The ISD stipulated the minimum rules applicable to investment firms and left a great deal of discretion to individual member states to stipulate conduct of business rules, such as ‘Know Your Customer’ rules. This arrangement insufficiently facilitated cross-border investment services in Europe. MiFID was intended to fix this.

MiFID created consistent regulations for investment services across the member states of the European Economic Area³, with all participants subject to a similar regime. MiFID retained the principles of the EU ‘passport’ introduced by the earlier Investment Services Directive (ISD) but introduced the concept of ‘maximum harmonisation’ which emphasised home state supervision.

In 2009-2010 the European Commission conducted a review of certain MiFID provisions which the terms of the Directive had made obligatory. The financial crisis of 2008 exposed weaknesses in the regime, for example a lack of transparency, particularly in the non-equities market. The legislation also had to be updated to keep pace with the growing complexity of technology and financial innovation. On top of this the products and services had increased in number and complexity and this necessitated an enhanced level of investor protection. This review resulted in a consultation paper which was published by the Commission in December 2010 on changes to MiFID, followed by formal proposals for a revamped Directive (‘MiFID

II’) and new Regulation (‘MiFIR’) in October 2011. After an extensive legislative process, the final versions of the Directive and Regulation were published in June 2014. The requirements in MiFID II regarding consumer protection for investment firms are:

1. to align products and target markets (product approval and review process);
2. to disclose all costs of the various investment services and financial instruments and provide the investor with insight into the cumulative effect of costs on return;
3. in relation to investment advice:
 - to explain the basis on which they give investment advice, in particular on the range of financial instruments or a bundle of financial instruments they are considering;
 - to determine whether they provide advice on an independent basis;
 - to inform clients whether they will periodically assess suitability; and
 - to explain to clients the reasons behind the advice the firm provides.

In addition to MiFID II, so-called ‘level 2 legislation’ was published on 25 April 2016⁴ entailing further specification of the requirements mentioned in the key articles of MiFID II. For example, where Article 25 of MiFID II requires an investment firm to obtain information on a client’s financial position, the delegated regulation specifies that, where relevant, information must be obtained on regular income, assets, investments etc. Level 3 measures (guidelines and recommendations) are in the process of being finalised.

2.2 MiFID II timelines

The initial compliance deadline for investment firms was set at 3 January

2017. Despite this, it was on 17 June 2016 that the EU Council published the texts of the legislative package which postpone the application date of MiFID II and MiFIR from 3 January 2017 to 3 January 2018. The changed MiFID II timelines resulted in a change to the deadline for the member states to implement, where necessary, the regulations in national legislation (to 3 July 2017).

2.3 Suitability & Appropriateness

2.3.1 Introduction

The scope of this whitepaper is limited to a suitability and appropriateness assessment. This chapter provides the regulatory context for the suitability and appropriateness assessment which was introduced by MiFID. The content of this white paper mainly refers to key articles of MiFID II (Art. 24 and Art. 25).

The implementation of suitability and appropriateness within MiFID II is initially based on a clear understanding of both suitability and appropriateness. Furthermore the scope of investments services covers, where applicable, advised services such as investment advice and portfolio management or non-advised services (execution only) such as order execution or the primary market placement of financial instruments.

Suitability

When providing investment advice and/or portfolio management, the information obtained from the client by investment firms must ensure that a suitable recommendation is made to the client. Table 1 shows an overview of information that has to be obtained according to the rules.

³ The 28 EU member states plus Iceland, Norway and Liechtenstein.

⁴ Commission delegated regulation (EU).../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

The suitability requirements apply to both professional and non-professional clients (also called ‘retail clients’). However, the investment firm is allowed to make certain assumptions in the case of professional clients. Such assumptions only work if the client has correctly been classified as a professional client. During this classification process the firm must make sure that the client has sufficient knowledge and experience in order to be considered a professional client. Given that this assessment has been done as part of the client classification process, it does not need to be repeated for suitability purposes. However, some of this information (which is not necessary from a MiFID perspective) may be relevant for the firm when it comes to making a sound recommendation to the professional client.

Appropriateness

When providing investment services without advice (meaning that the suitability requirements do not apply) such as execution only services, firms must assess whether the financial instrument or service is appropriate for the client. To this end the investment firm must ask the non-professional client for information on relevant knowledge and experience if clients want to trade in regulated complex financial instruments. The overview in table 2 shows the information that has to be obtained.

In an overview, the suitability and appropriateness assessment for non-professional investors under the current MiFID has to meet the following requirements (See table 3).

2.3.2 Suitability

When assessing suitability the investment firm must obtain the necessary information regarding the knowledge and experience of the client (or of representatives in the event of institution or company), the client’s financial situation (or that of the institution or company) and the client’s investment objectives (or that of the

Table 1. Requirements for assessing suitability

Information to be obtained when assessing suitability	Requirements
Client’s knowledge and experience ⁵	<ul style="list-style-type: none"> the types of service, transaction and the regulated investments with which the client is familiar; the nature, volume, frequency of the client’s transactions with regulated investments; and the level of education, profession or (if relevant) former profession of the client.
Client’s financial situation* ⁶	<ul style="list-style-type: none"> the source and extent of the client’s regular income; the client’s assets, including liquid assets, investments and real property; the client’s regular financial commitments; the ability to bear losses.
Client’s investment objectives	<ul style="list-style-type: none"> the client’s investment horizon; the client’s risk preferences, risk profile and risk tolerance; and the purposes of the investment.

Table 2. Requirements for assessing appropriateness

Information to be obtained for purposes of assessing appropriateness ⁷	Requirements
Client’s knowledge and experience in order to enable the firm to determine whether the financial instruments and services envisaged are appropriate.	<ul style="list-style-type: none"> the types of financial service, transaction and regulated financial instruments the client is familiar with; the nature, volume and frequency of the client’s transactions in regulated financial instruments; and the client’s level of education and profession (or former profession).

Table 3. Bringing it all together - Requirements for three types of investment services

Assessment requirements		Execution Only	Investment Advice	Discretionary Portfolio Management
Suitability	Investment objectives		✓	✓
	Financial situation		✓	✓
Appropriateness	Knowledge & Experience	✓	✓	✓

⁵ Investment firms are entitled to assume this requirement is satisfied when dealing with professional clients.

⁶ Investment firms providing investment advice or portfolio management are entitled to assume this requirement is satisfied when dealing with professional clients (i.e. non-opted up professional clients).

⁷ Firms may assume that the intended service is appropriate if dealing with professional clients and Eligible Counterparties (ECPs).

institution or company) to enable the firm to recommend suitable investment services and financial instruments to the client or potential client.

In the event that the investment firm does not receive sufficient information from the client to enable an assessment of the suitability, the investment firm will not be allowed to recommend investment services or financial instruments to the client.

Investment firms which provide investment advice or offer portfolio management are also obliged to carry out suitability checks on behalf of the investor on a transaction by transaction basis. In addition to the requirements concerning suitability, as introduced by MiFID, MiFID II also introduces the obligation to provide retail clients with suitability reports, as clarified by the ESMA Technical Advice⁸. The key requirements on suitability reports within the framework of the ESMA Technical Advice are shown below.

Reports to clients of the investment service must include periodic statements which take account of the type and complexity of financial instruments and the nature of the service delivered. Investment firms that provide investment advice must submit a statement of suitability before the transaction is carried out, or immediately after the client becomes bound, which statement will specify how the advice given meets the client's preferences, objectives and other characteristics. In the case of portfolio management, the periodic report must contain an updated suitability statement.

The overview below shows the suitability requirements under MiFID II:

Recommendations to hold/sell and/or switch financial instruments

Whereas the MiFID Implementing Directive currently imposes suitability requirements when recommending a financial

instrument to a client, MiFID II clearly states that suitability obligations also apply when issuing a personal recommendation⁹ to a client to buy, hold, sell, subscribe for, exchange, redeem or underwrite financial instruments. Based on the client's preference pre-trade suitability testing has to be performed on (the bundle of) the financial instrument(s).

For example, in the event that a non-professional client is advised to sell instrument X and to buy instrument Y, the result of both actions should be assessed against the client's preferences and objectives. This needs to be assessed before the transaction is actually carried out.

Ability to bear losses

The investment firm needs all the relevant information to determine the suitability of the investment services. It also has to ensure that the (bundle of financial) instrument(s) is/are in line with the objectives and are in accordance with the risk tolerance and ability of the client to bear losses.

In the event of investment advice which recommends a package of services or financial instruments, the overall combined package has to be suitable. The investment firms will provide information about the suitability of the advice, specifying how the advice meets the client's preferences, objectives and other characteristics, before the transaction is carried out.

Collection of reliable information

Firms must take reasonable steps to ensure that information collected from clients is reliable including:

- ensuring that clients are aware of the need to provide accurate up-to-date information;
- carrying out valid and reliable assessments of the client's knowledge, experience and risk tolerance;
- ensuring that tools used to assess suitability are fit for purpose;
- ensuring that questions asked are understood by clients; and
- taking steps to ensure the consistency of client information and determining whether responses are obviously inaccurate.

Multiple client entities

Investment services are provided not only to consumers but also to (small) companies and foundations. Wherever the framework for determining suitability is unclear, the company or foundation must put a policy in place and decide, together with the client, who will be the subject of the assessment. It is up to the investment firm to determine how the assessment will be carried out in practice.

In the case of a company with two shareholders, which of the two shareholders is responsible for the investment decisions, or are both of them responsible? Alternatively, is someone who works for the company responsible for the investment decisions? This needs to be clear when providing investment services for suitability purposes such as knowledge and experience.

In the event that a client needs additional income on top of his pension, it is important that the investment firm firstly establishes the amount needed and determine for how long it is required, after which an assessment needs to be made which investment profile will facilitate this goal (additional income). After that, an analysis will have to be made which investment losses may be suffered (on the basis of a scenario analysis) and what impact this can have on the additional income. One important question for the investment firm is whether the client can cope with these possible losses. Whether or not this is the case has to be carefully determined.

⁸ Article 2.17 of ESMA's Technical Advice to the Commission on MiFID II and MiFIR of 19 December 2014.

⁹ Article 9 of the Commission delegated regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.



Suitability reports

Suitability reports will need to include:

- an outline of the investment advice given;
- an explanation of why the recommendation is suitable, including how it meets the client's (person/ persons or entity) objectives and (personal) circumstances with reference to attitude to risk and capacity for loss;
- a statement that informs the client as to whether a periodic review of suitability will be performed and how; and
- a statement to the effect that a periodic report may be in the form of an update to, and refer to, a previous suitability report¹⁰.

In the event of portfolio management it is mandatory to perform a periodic assessment of suitability that results in a report with an updated statement of how the investment meets the preferences, investment objectives and other personal characteristics of the non-professional

client. Furthermore, any periodic report should only cover changes made since the last report.¹¹ Investment firms that provide a periodic suitability assessment should review the suitability of the recommendations given on (at least) an annual basis. The frequency of this assessment will have to be increased depending on the risk profile of the client and the type of financial instruments recommended. It is not clear whether the frequency of reporting to the client has to be increased as well.

The suitability statement in the reports to clients is new under MiFID II. This will require client reports to be enhanced with regard to the financial situation, suitability and appropriateness. Moreover, investment firms will be required to ensure, and demonstrate to regulators on request, that investment advisors possess the necessary knowledge and competence to fulfil their obligations.

2.3.3 Appropriateness

When assessing appropriateness the firm must assess:

- whether the client has knowledge and experience regarding non-advised services (execution only);
- whether the financial instrument is appropriate for the client, taking its knowledge and experience into account.

If a specific type of instrument or service is not appropriate, a warning must be issued (in a standardized format). If no information is provided by the client this also needs to be signalled by the investment firm. The assessment, the information given and the signals must also be recorded.

¹⁰ Article 54(12) of Commission delegated regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

¹¹ As required under Article 25(9) of MiFID II, these guidelines specify the criteria for the assessment of the necessary knowledge and competence requirements of investment firms' staff. See report 'Guidelines for the assessment of knowledge and competence' of ESMA (17 December 2015).



When it comes to execution only services, the appropriateness assessment is unnecessary under the current MiFID (I) regulation if:

- the client(s) wishes to invest in non-complex financial instruments (shares traded on regulated markets, money market instruments, bonds or other debts, investment funds);
- the service (execution only) is performed on the clients initiative;
- the client(s) is made aware that the investment firm is not obliged to test appropriateness;
- the investment firm has fulfilled its obligations with regard to conflict of interest.

MiFID II narrowed the categories of so-called 'non-complex' instruments. The 'appropriateness assessment' will then apply to:

- shares unless they are traded on a regulated market (or third country equivalent) or MTF;
- shares in a non-UCITS collective investment undertaking or shares that embed a derivative;
- structured UCITS;
- bonds and other forms of securitised debt unless they are traded on a regulated market (or third country equivalent) or MTF;
- all debt instruments that embed a derivative or incorporate a structure which make it difficult for the client to understand the risk involved;
- structured deposits that incorporate a structure which makes it difficult for the client to understand the risk or return or the cost of exiting the instrument before term.

ESMA acknowledged that, because MiFID II covers more instruments than MiFID I, extra instruments will be considered 'complex'. The result will be an extension of the scope for the appropriateness assessment i.e. expanded list of complex financial instruments. In practice this means that, in almost all cases, the appropriateness of the service and

the financial instruments used should be assessed for clients wishing to use execution only services.

ESMA also stipulates that instruments which are expressly excluded from the 'non-complex financial instrument' definition are automatically complex and cannot go through the separate complexity assessment to see if they fall within the definition of a non-complex instrument. ESMA has also added two criteria for the separate 'non-complex' assessment:

- it does not include a clause / condition / trigger that fundamentally alters the nature or risk of the investment or pay out profile;
- neither does it include explicit or implicit exit charges which make the investment illiquid.

Recordkeeping

MiFID II has also introduced new recordkeeping requirements. This means that investment firms must keep records of their appropriateness assessments. These records should include:

- the result of the appropriateness assessment;
- any warning given to the client that the investment service or product purchase was assessed as potentially inappropriate for the client, that the client asked to proceed with the transaction despite the warning and, where applicable, that the firm accepted the client's request to proceed with the transaction;
- any warning given to the client that he did not provide sufficient information to enable the firm to undertake an appropriateness assessment, that the client asked to proceed with the transaction despite this warning and, where applicable, that the firm accepted the client's request to proceed with the transaction.¹²

¹² Article 56(2) of Commission delegated regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.



3. Practical impact of suitability & appropriateness

3.1 Introduction

Although a larger number of the level 2 rules are laid down in regulations in the case of MiFID II than in the case of MiFID I, the texts for MiFID II are still fairly abstract and often ambiguous. The regulation has a direct effect and does not have to be translated into local legislation and regulations. The result is a more Single European Rulebook and, what is more, the ESMA guidelines and Q&As are more relevant.

More and more member states are also using guidelines to apply the rules in practice. In recent years, ESMA has provided these guidelines for the practical customization.¹³ This information has been included in the following points for attention.

With respect to suitability assessments the question is whether a questionnaire which consists of qualitative-related questions is sufficient, or whether objectives have to be quantified as well? Is it sufficient to determine whether assets are used for 'pension' or should this goal be made more specific? In this instance, should an assessment be made to show what the pension arrangement looks like and which (additional) amount is needed at which point in time? Obtaining adequate information can be a major challenge. Another challenge is to include the relevant details of the assessment in the investment advice as well.

This chapter examines in more detail the various practical implications of introducing the MiFID Directive with regard to the suitability and appropriateness assessment in the case of non-professional clients.

3.2 Suitability at account or client level

Articles 24 and 25 of the Directive 2014/65 indicate that the financial situation and the objectives of the (potential) client(s) must be assessed. In practice, an investment advice is given on the assets invested with the investment firm only, rather than the total assets of the client which may be invested elsewhere. In Directive 2014/65 it is clear that information regarding the financial situation of the (potential) client has to include information on the source and extent of his regular income, his assets, including (il)iquid assets, investments and real property, and his regular financial commitments.

The question is how the assets held at other firms are to be included in the analyses and the investment advice. In many cases the suitability is, in daily practice, still determined using a qualitative questionnaire, with the answers being given a score and then translated into an investment profile. This is based on one account with one investment profile and one objective, whereby the objective is not made concrete.

A client can have several accounts and several connected investment profiles. In the event of there being several accounts, the question is how these are related to one or more objectives and what that means for the risk profile at 'client level'. There are a number of special points for attention associated with MiFID II.

3.2.1 Specifying objectives

Many investment firms refer to client's 'goals'. A typical difference between goals and 'objectives' is that the latter are bound by time and have been quantified.

Consequently, in many processes the client's objectives are not yet specified.

A client (58) indicates that he wants to invest his assets worth € 250,000 to create a pension provision. This, in itself, can be a 'goal'. A clearer picture can be created by making the goal quantitative and time-related. It transpires that, in 9 years' time, when the client is 67 years old, assets worth € 780,000 would have to be in place for a satisfactory additional pension. This would be indicated as an 'objective'.

It is then essential to gain a clear insight into the feasibility of the objectives. What is the client's current financial situation and which measures have to be taken to make the financial objectives feasible? Another question is whether these measures suit the client's risk appetite for his pension provision?

A client has completed a qualitative questionnaire and this has generated a 'neutral investment profile'. The client is going to invest in order to pay off a mortgage of € 300,000. His investable assets are expected to be € 200,000 (50% probability). In a poor economic scenario this will end up at € 150,000 (90% probability) and in a good economic scenario at € 310,000 (10% probability).

Is the 'neutral investment profile' suitable in this case? Although the objective has been defined, it is not realistic that it will be achieved. In order to manage the expectations properly it is, in any

¹³ Example: 'Guidelines on certain aspects of the MiFID suitability requirements', August 2012.

event, important to inform the client about the terminal values, the values at the investment horizon. If the objective needs to be realistic, the client will have to contribute more, invest differently or change his objective. The same applies to, for example, pension objectives and other objectives.

3.2.2 Dealing with several objectives

Another point of attention in the context of the current method of most questionnaires is how we should deal with a client that has several objectives and/or several savings and investment accounts. In practice this appears to happen frequently. Although most clients find it difficult to define an objective for their assets, better methods are becoming available which could help them to do this. During the intake and advisory processes, investment firms will have to facilitate the following situations:

- A single objective for one account;
- A single objective with several accounts;
- Several objectives and one account;
- Several accounts with several objectives.

A single objective for one account

This is a standard situation these days. The investment profile links up with the client's objectives. One point of attention is how other assets are taken into account.

A client has € 100,000 in an investment account and € 800,000 in a savings account at another bank. The investment profile of the € 100,000 is 'neutral'. Will an assessment be made of the risk of the assets in the investment account in question or will the basis be the risk of the total assets (in this case € 900,000)? It is, in any event, important to communicate this point of departure clearly to the client and to indicate whether and how this has been included in the advice.

A single objective with several accounts

Various situations are imaginable in which a client's objective can be achieved with several assets. For example, clients aim to achieve a decent pension and try to realise this via pension products and freely investable assets.

A client has the objective of ensuring a decent pension or, in other words, sufficient income for the expected expenditures from the age of 65. This means clarity is needed with regard to which (pension) assets are required. As soon as it becomes clear which additional income is needed, the calculation can be made to determine the contribution required to achieve this goal based on a certain risk level. This can only be done if the goal is specified.

Several objectives with one account

In the event of there being several objectives, it is important to define how priorities are taken into account. If, for example, a client has three objectives and the two least important ones are realised and the most important one is not, the requirements of suitability will not have been properly met and the client will eventually be dissatisfied.

The question is then which investment profile belongs to which objective? If a client is saving for his pension, he will, in many cases, take a cautious approach. However, if a client invests a small portion of his assets in order to maximise capital growth, he will probably invest offensively. If a client has two goals, 'extra retirement income' and 'maximise capital growth with different risk profiles', he will have to open two separate accounts. In the event that a client has two goals and wants to invest via the same risk profile, the moment in time at which the goals have to be realised must also be taken into account.

A client wants to save to finance his children's further education (in 5 years' time) and wants to save for his pension (he will retire in 20 years). The pension objective has the highest priority, but has to be realised later in time. If the assets are used to finance the children's studies, there is a risk that too little is left for the pension. It is then a good idea to split the account so that the client can determine the level of security with which the pension objective can be achieved. The remaining assets can be used to finance the children's studies.

In the event that a client has two objectives and wants to invest with the same investment profile and the objective with the highest priority has to be achieved at an earlier point in time, it may be sufficient to use one account if the investment risk links up with the minimal horizon. The only reason to take a different approach would be 'mental accounting'. A client may find it more convenient to have two separate accounts for two separate goals.

Several accounts with several objectives

Although this situation will arise in practice, it is more complex to manage. This can be made clear by the following example.

A client has an account in order to save for his children's studies and a different account to save for additional pension. At a certain point in time, the children will start their studies and there is insufficient money left over to finance their final years. While some parents would then say 'go get a job', there will be others who will start using the account intended for pension in order to supplement the children's study account. In the situation in which the children themselves go out to work, you will still have one account with one goal. In the event that the pension account is available, one account will be used for several goals with 1 goal using two accounts (children's studies).

Taking account of the total assets

Proper implementation of the 'Know Your Customer' principle will require knowledge of the client's entire financial situation. In practice it is proven that documentation in this field has been vastly improved in recent years, encouraged partly by the large amount of data which is digitally available, for example tax overviews and (payment and asset) data from banks. This improved availability of data means that the crucial question of 'how to deal with the other assets (of other banks)' is becoming more and more relevant. The various assets can be accommodated at a bank, or at several banks.

For example, a client can have two accounts with the same investment firm in the form of an execution only account and an asset advice account. The question is to what extent, in the case of the advice account, an investment adviser also has to take into consideration the execution only account in his investment advice and whether he should also consider the savings held at a different bank? Due to the legislation in the field of the 'Know Your Customer' principle, the investment adviser will also have to take account of the available information from other accounts.¹⁴ This also means taking broad account of all assets. It does not mean that the individual instruments in the execution only account have to be taken into consideration and – from a legal perspective - will have to play a role in the suitability assessment for the investment advice of the specific account.

Nevertheless it should not be the case that, if a client holds several accounts with one investment firm, the risks of the execution only account are not considered in general terms and consequently not included in the investment advice. An investment firm should be expected to do this given its moral duty of care.

3.2.3 Financial planning

In many of the aforementioned cases it will be necessary, in order to carry out a proper suitability assessment, to gain an insight into every aspect of the client's financial situation. In this context it can be useful to draw up a general financial plan. In this, special attention should be paid to:

- The client's possessions and debts and those of his or her related entities. It would be ideal to take (in general terms) fiscal claims into consideration as well;
- Insight, in general terms, into the client's pattern of income and expenditure. Special attention needs

to be paid to pension provisions or annuities and the financial 'health' of these provisions;

- Insight into the client's objectives, quantified in time and amount.

In this way it can be established – in the event of, for example, a pension objective - whether there will be sufficient income during the pension period to finance the desired expenditures. In order to be able to assess this, all possessions and debts and income and expenditure will have to be taken into account. In the event of several objectives, prioritisation will be required in conjunction with the various assets.

It will also be essential to obtain a proper insight into the personal financial circumstances in order to advise the client properly during his lifetime. Each phase of life is characterised by specific points that require financial attention, such as employee disability, death and retirement. Regular updating will be necessary in order to be able to continue offering a suitable investment policy, both in terms of advice and portfolio management.

3.3 Calculating the maximum loss capacity

Under MiFID II, a client's maximum loss capacity will also have to be established. This means that investment firms will not only have to determine the client's financial and emotional risk appetite, but also the capacity to cope with financial loss.¹⁵ At this stage it is not yet entirely clear how this should be detailed. For the sake of transparency it is, in any event, important to agree the analysis points of departure with the client. The points of departure are primarily relevant for the scope of the analysis, for deciding which elements are to be included, how the loss capacity is to be measured and what the consequences are if the loss actually occurs. In our opinion a qualitative assessment is insufficient, while a quantitative analysis is more logical when determining the degree of loss.

In order to ensure a transparent advisory process, it is important to define how the maximum loss capacity is calculated. The maximum loss capacity can be defined by providing insight into the consequence of low and/or negative returns as a consequence of disappointing market developments, for example capital loss, as well as long-term low interest. If this low interest and/or negative returns occur for one or more years, this may affect both the extent of the asset development and the level at which, and period during which, withdrawals can be made from the assets.

The question will then be what impact this has for the client. If, for example, the occurrence of a loss affects gifted donations to children, the impact will be different compared to a situation in which the desired supplement to the pension income has stopped.

When defining the 'maximum loss capacity', we believe that the following points need to be established and communicated to clients:

- Are we talking about only the investable assets on the account in question, part of the assets or all the assets?
- Is the maximum loss capacity related to the financial objective and/or the assets (and which assets)?
- Does the analysis relate to the first years or a different point in time during the investment horizon?
- What are the consequences if the objective is not realised? Will this have a major impact on the client (for example in the event of the loss of pension income) or is the impact limited (for example fewer assets than expected)?
- Determine the frequency at which the analysis is updated and communicated to the client.

The report should contain an indication of how the investment advice fulfils the client's preferences, objectives and other characteristics and what are the consequences in the event of a negative market development. In other words, it is

¹⁴ Article 54 (7) of Commission delegated regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

¹⁵ Guidelines on certain aspects of the MiFID suitability requirements' by ESMA, 21 August 2012/387; paragraph, p.8. Footnote 9 reads: 'A client's ability to accept losses may be aided by measuring the loss-sustaining capacity of the client'. ESMA/2014/1569, Final Report – ESMA's Technical Advice to the Commission on MiFID II and MiFIR (19 December 2014), p. 156 (no. 2).

A client wants to supplement his pension over a 20 year period via € 20,000 withdrawals from the investable assets of € 350,000, taking costs and inflation into account. This will be feasible based on the expected 5% return of a balanced portfolio. The question is what the maximum loss capacity is in this case.

This question can be answered in different ways. The possibilities are as follows:

- In the event that the market develops as expected, it will be possible to withdraw € 20,000 per year over a 20 year period;
- In the event of poor market development, for example 90% of all economic scenarios, the desired withdrawals can be made for a minimum of 16 years. In other words there is a 10% probability that within 16 years there will be insufficient assets available to make the desired withdrawals due to poor market circumstances.
- If a certainty of the withdrawal is required of 95% over the entire period (20 years), the withdrawal must be reduced from € 20,000 to € 17,000.

important that it becomes clear why the financial instrument, or the collection of financial instruments, links with the client's wishes and objectives. This exceeds the current method of using a questionnaire and allocating points. Although there is no obligation to do so, an indication of the liquidity of financial instruments can also play a role.

In any event, transparent and clear communication with the client in all the above-mentioned situations is important.

3.4 Switching

Before recommending a course of action (both when providing investment advice or portfolio management) that involves

switching investments, a firm must collect information on the client's existing investments and the recommended new investments and will undertake an analysis of the costs and benefits of the switch, such that they are reasonably able to demonstrate that the benefits of switching are greater than the costs.¹⁶ It goes without saying that, besides an analysis of the costs and benefits, the investment firm should perform a pre-transactional suitability test.

A client wants to sell a share investment fund and purchase a bond fund as part of an investment portfolio. The investment firm will assess whether the investment profile, the collection of financial instruments, still links up with the client's objective. The investment firm also assesses whether the costs and revenues from this purchase and sale transaction can be expected to make a better contribution to the realisation of the client's objective.

3.5 Collection of reliable information

Obtaining, interpreting, processing and recording information are essential elements of the suitability assessment. The investment firm has the legal obligation to obtain information from the client which is needed within the framework of the 'Know Your Customer' principle. However, the client is not (legally) obliged to provide this information. However, if the client does not provide the information, this will have an impact on whether the investment firm can actually provide the investment service at all. According to Article 54 (8) of the delegated regulation, if, in case of investment advice or portfolio management, the investment firm does not obtain the information required (according to Art. 25(2)), the firm will not be able to provide investment services or recommend financial instruments to (potential) clients. The way in which information is obtained from the client should, therefore, also be acceptable to the client.

The client must be encouraged as much as possible to provide information. This means that the necessity of obtaining this information must be made clear to the client. The importance of this for the client must also be emphasised. It should be noted that the client bears some of the responsibility for updating information. The investment firm must convince the client that the regular issuing of new information is also in its own interest. This is applicable in the case of both portfolio management and investment advice.

Moreover, the chosen method of obtaining information must be as acceptable as possible. 'Simplicity' and 'limited burden of time' are important concepts in this regard. A situation has to be avoided in which the client starts thinking that the required information, and then preferably bearing the client's signature, is primarily used as a legal means for the investment firm to protect itself.

A high degree of cooperation on the part of the client is also needed given the very limited 'sanctioning possibilities' open to the investment firm. Although the investment firm should stop providing services, in practice this is no easy task. On one hand, it appears to be difficult to say goodbye to a client and, on the other hand, 'resetting' to an execution only service also produces legal and ethical issues. After all, what does the investment firm do if it knows that, without adequate supervision, the client will make irresponsible investment transactions? Under MiFID I, the investment firm has discretionary freedom to determine that specific information, which the client does not wish to provide (or only to a limited degree), is not needed for the proper execution of the suitability assessment. What should be done if this concerns a valued, and commercially attractive, client? This produces a dilemma: Should the investment firm 'demand' the information, or is it preferable to save the relationship? However, there can be all kinds of reasons why information cannot be obtained from the client. The client may be unwilling, for

¹⁶ Article 54 (11) of Commission delegated regulation (EU) of 25 April 2016, supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.



example for reasons of privacy, or it may be that information is simply not or no longer available. One example would be the pension letter of a director and principle shareholder of a private pension company.

In instances whereby a client only wishes to provide some of the information, or situations in which the investment firm knows, or reasonably should know, that the information obtained is incomplete, incorrect or outdated, it is perfectly conceivable that the investment firm will consult several sources in order to obtain the necessary information after all. The reliability and relevance of the sources also determine whether this information is usable. Although a simple 'google' search can produce a lot of information, in quite a few instances it will be very biased or even incorrect. Official sources such as the Chamber of Commerce of the Land Registry may then offer a partial solution. Commercial institutions involved in collecting information, such as business information or news, can, provided the quality is high, be used in order to fulfil the requirements of the 'Know Your Customer' principle. It is therefore also important

to have a good insight into the types of information which have to be obtained within the framework of fulfilling the 'Know Your Customer' principle. There are three types:

Statistical information: Examples are aspects such as age and gender. Generally, this information does not change (e.g. gender) or, at most, at a fixed frequency (e.g. age). In some instances this information can change due to important events in life (e.g. marital status). Generally speaking this information can be used verbatim or almost verbatim.

Factual, frequently changing information: This information is factual in nature and can usually be used verbatim. The date in question may concern income, possessions/debts and the pension level. Although this information can be used verbatim, this does not mean it will not change at (very) regular intervals. Such information is used to support a normative judgement. For example, if the liquid investments and savings in a private pension provision amount to more than 120% of the commercial pension provision,

the other assets can be used for more offensive investments.

Supporting information: This information serves to support a subjective judgement. In this, it is difficult to compare the information obtained with reference people. Any assessment of this supporting information will almost always be of a (strongly) subjective, interpretative nature. An example is information about investment knowledge and experience. Whether the client has much or little knowledge under certain circumstances will depend on the assessor's frame of reference. Although the information needed for this subjective judgement can partly be used verbatim, such as number of years' experience with the 'investment advice service' or number of transactions performed in a certain period, it still has to be processed somewhat in order to be usable for (part) of the suitability assessment. In practice, making good 'tooling' and training available for the assessor will be essential in order to make a proper assessment. In this way the investment firm can also keep a certain grip on the parameters used to reach a judgement.

3.6 Reporting requirements

The requirements for reporting to clients of are strict and will become more so under MiFID II. Paragraph 2.3.2 describes the requirements imposed on reporting.

- Reports issued to clients are subject to strict guidelines. As far as *investment advice* and *portfolio management* are concerned, two types of reports are important:

Investment advice reports

In the case of investment advice, the transaction(s) must be stated along with a specification of the advice given and the suitability of the financial instrument or collection of financial instruments (investment portfolio). Important elements of the suitability report are the client's attitude to risk and insight into the client's maximum loss capacity.¹⁷ Another important issue is the reporting on the periodical suitability assessments. The most important requirements of a suitability report are:

- a description of relevant information (questionnaire, projected returns, etc.), as a basis of the 'suitability assessment';
- an explanation of why the recommendation is suitable, including how it meets the client's financial objectives and relevant personal information for advice;
- a statement bringing to the client's attention the need for a periodic review of suitability.

The reports must be periodically issued to the client and also before the transaction for a financial instrument is executed. In the case of investment advice this means that, for each transaction, the suitability assessment has to be carried out with regard to the entire portfolio and checked against the client's objectives.

If it is not possible to share the suitability report prior to the transaction, it can be issued after the transaction as well, subject to the following conditions:

- The client has consented to receiving the suitability report without undue delay

- after the conclusion of the transaction;
- The investment firm has given the client the option of delaying the transaction in order to receive the report on suitability in advance.

In the suitability report it is desirable, within the framework of responsibilities, to provide separate descriptions of the advice given by the investment adviser and the client's eventual choice. At this point in time it is not entirely clear in what form a suitability statement like this must be issued. It can be assumed it will be issued on a durable medium.

Portfolio management reports

Reports of executed transaction(s) with a statement of work performed. An updated explanation of the suitability assessment should also be included and of the way in which the client's wishes and objectives can (still) be fulfilled, including the risk tolerance.

The written statement must be issued on a durable medium¹⁸. It is important that there is insight into why the investment profile links up with the client's wishes and objectives.

Content of reports

In practice the aforementioned reports consist of the following elements:

- A record of the type of service and the relevant points of departure (advice, portfolio management);
- A record of the investment knowledge and experience of the client(s);
- A record of the investment portfolio details;
 - The type and complexity of the financial instruments;
 - The management fee, administrative costs, transaction costs, etc.;
 - Insight into the risks and the return;
- A record of the financial situation and the client's objectives:
 - Financial situation: regular income, his assets, including liquid assets, investments and real property, and

his regular financial commitments.

- Concrete objective (amount(s) and horizon) and, in the event of several objectives, a prioritisation as well;
- A record of the suitability, clarification of the advice given and accompanying substantiation:
 - Risk that a client is willing and able to take;
 - (Emotional) attitude to risk of the client(s);
 - Insight into the short-term risk of the portfolio (1 year);
 - Insight into the long-term risk of the feasibility of the financial objective, the development of capital in the event of a positive, expected and negative market development;
 - Insight into any consequences of a negative market development (maximum loss capacity);
- A record of the points of departure and agreements:
 - The way in which the client is to be (periodically) informed;
 - The way in which the financial institution interprets the monitoring of 'suitability' if this has been agreed with the client;
- Any disclaimer stating what is and is not included in the investment advice and the investment service.

It is important to assess how much information is effective for the client and in which form it is used, graphically, numerically, as an image or in a combination of various forms, in order to transfer the information efficiently and understandably.

The report must be clearly legible for the client and also clearly indicate the points of departure of the investment service and the instrument. This applies in particular to the elements of risk, return and costs.

¹⁷ Articles 25.2 and 25.6 of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU Text with EEA relevance.

¹⁸ This must be done in such a way that the client can save the personal information received in a way that said information remains accessible for future use. This should be in line with the purpose for which the information is intended and in a way which makes it possible to present the saved information unchanged.

Under MiFID II, investment firms that provide portfolio management will have to inform the client whenever the overall value of the portfolio, as evaluated at the beginning of each reporting period, depreciates by 10% and thereafter at multiples of 10%. This should be done no later than the end of the business day during 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.¹⁹

Furthermore, if a non-professional client has holdings in leveraged financial instruments or contingent liability transactions, the investment firm will inform the client, whenever the initial value of each instrument depreciates by 10% and thereafter at multiples of 10%. This should be done at instrument level.

All the above-mentioned reports can to a large extent be largely automated and made available digitally provided nothing has changed as far as the client is concerned. If the client's circumstances (e.g. objectives or financial situation) have changed (significantly) a new assessment will have to be carried out to determine suitability.

Besides further automation, employees with client facing positions (investment advisers and investment managers) will have to be trained in the proper interpretation of suitability. They will also have to be able to clarify all results and explain why the investment advice has been given, or the portfolio management has been executed in this way.²⁰

3.7 Monitoring/risk management

3.7.1 Updating information on behalf of the suitability assessment

The information obtained from the client or from another reliable source, almost

never has an absolute nature and is subject to changes (see paragraph 3.5). As a result, the investment firm runs the risk that the suitability assessment is carried out incorrectly with all possible negative (financial) consequences for the client. Updating is therefore essential. In addition, investment firms that have an on-going relationship with the client in the field of investment advice or portfolio management, are obliged to have policies and procedures in place that allow them to demonstrate that they have up-to-date information from their clients.²¹ However, the question is how frequently should the information be updated and how? What is more, under MiFID II, the investment firm also has to check the information obtained for obvious inconsistencies.²²

A client states that he has worked abroad all his life and is going to start enjoying his old age pension at age 67. In such a situation the investment firm ought to ask whether the state pension premiums were paid during the period of time that the client was abroad.

The investment firm has to indicate the frequency. Particularly in investment advice, the investment firm will have to indicate whether a periodical reassessment has been issued to the client and how this is going to be issued in the future, as well as the frequency, which is dependent on the client's risk profile and the type of financial instruments advised. No matter whether or not a suitability statement is periodically issued, the investment firm must periodically update the information. Information technology can also play an important supporting role. By annually drawing the client's attention to the need to update information and to check existing information, and partially update it via the investment firm, a high level of information hygiene can be achieved. Nevertheless, in certain circumstances, for example

major events in life (e.g. a divorce or the purchase of a home) clients must update the information themselves. Nevertheless it is insufficient simply to state this in terms and conditions or disclaimers and hope that the client will read them. The investment firm needs to take a proactive approach. This can be done by drawing the client's attention to the need to give notice of any changes, when periodically updating existing information.

3.7.2 Updating information on behalf of the appropriateness assessment

Although for non-advisory or investment management services, i.e. execution only services, it is also relevant to update information. Article 55 (3) of the delegated regulation states that an investment firm is entitled to rely on information provided by clients. However, even in the case of the appropriateness assessment, it can be relevant to obtain new information on the client's investment knowledge and experience with regard to a financial instrument or the investment service. This is certainly necessary if the knowledge and experience of trading in a certain financial instrument has not previously been assessed. Furthermore, if information is manifestly out of date, inaccurate or incomplete, the investment firm should ensure that the information is updated. This means that a certain update procedure should be in place.

3.7.2.1 Monitoring bandwidths

As soon as the investment firm has carried out a suitability assessment on the basis of the information obtained, the client will have to be informed about the advice provided by the investment firm. If there is agreement between the client and the investment firm regarding how to invest, investments will start. Part of the agreement between the client and the investment firm will be a description of the applicable asset mix with bandwidths (investment profile). It will also be agreed,

¹⁹ Article 62 of Commission delegated regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

²⁰ Guidelines for the assessment of knowledge and competence' from ESMA of 22 March 2016 (ESMA/2015/1886).

²¹ Article 54(7) of Commission Delegated Regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

²² Article 54(7d) of Commission Delegated Regulation (EU) .../... of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive.

for example, that an investment profile designated as 'neutral' will have the following spread (see table 4).

As long as investments are made within these bandwidths, the agreed investment profile will be fulfilled. The investment firm must actively ensure that, certainly in the event of portfolio management, investments always take place in accordance with these bandwidths. In the event of investment advice, advice must be given in accordance with these bandwidths. If these bandwidths are exceeded actively (due to a transaction that has been recommended or not) or reactively (due to price movements or additional payments/withdrawals), the client will have to be warned about the related risks. A durable medium ought to be used for this purpose. If the bandwidths are only exceeded by a relatively small amount, an automatic digital warning can be used. If the suitability of investments is immediately being jeopardised, a more insistent warning should be given (e.g. in the form of a letter followed by a telephone call).

3.7.2.2 Risk parameters within investment categories and at instrument level

Monitoring bandwidths does not mean that the material risks are under control. When the investment firm actually defines investment categories, deliberate or inadvertent additional risks can be taken initially or during the investment process. It is therefore essential that the entire investment risk of an active investment portfolio is regularly assessed regarding the initial assumptions. These risks can be monitored using four risk parameters. These parameters ought to consist of at least:

- the standard deviation per investment category;
- the correlations with other investment categories;
- relative weights per investment category (excessive idiosyncratic risks);

Table 4.

	Minimum	Maximum	Current allocation
Shares	30	50	35
Bonds	30	50	45
Alternative investments	5	15	12
Liquidities	5	15	8

- exogenous changes which cause a change in the character of the financial instrument, and therefore the risks, such as a significant decrease in liquidity or the downgrading of a company.

However, relevant risks can also arise within an investment category itself. Examples are risks which, although inherent in a (hybrid) financial instrument, are interpreted differently. For example, Contingent Convertibles (also referred to as 'CoCo's') can be classified by an investment firm as 'bonds', despite the client having a different perception of the 'bond' instrument. The risk that the principal sum can forcibly being converted into assets of the issuing institution (to support the buffer capacity) may imply an undesired – additional - risk.

The investment firm will have to set up a clear selection and assessment process for the financial instruments to be used as input for the monitoring. Initially, it can be determined whether instruments fulfil the criteria imposed on an investment category. The outcomes of this process will also have to be monitored during the investment process because risk parameters can change over time. One question, for example, is whether the initial - accepted - risk parameters on the basis of which corporate bond has been purchased are still applicable or whether (for example) market developments are having a negative effect on this decision-making? Assessing the effect against these criteria during the investment process will ensure that the integral investment portfolio does not produce any risk-related surprises.

3.7.2.3 Risks relating to the feasibility of the investment objective

There is also a third dimension related to risk management in the context of investment portfolios. The question that needs to be asked is whether the investment profile still actively contributes to the feasibility of the formulated investment objective? For example, a situation can arise in which the investment firm has to initiate a discussion of the suitability of an investment profile on the basis of – adapted - scenarios.²³ In addition, it is impossible for the investment firm to adopt an absolute position. After all, it is uncertain how, for example, the interest rate is going to develop in the coming years. By using information from the past and supplementing it with updated information and an expert opinion, it can be made clear to the client what the chances are of achieving the financial objectives and the consequences of not achieving the financial objectives. To be communicated via 'the ability to bear losses'. At that point, measures can be taken. These could include the deliberate lowering or raising of the risk, adapting of objectives, etc.

The financial feasibility of the objectives should be assessed with a certain regularity. The periodical assessment of feasibility, discussing this with the client and possibly anticipating the assessment are all ways of helping to ensure that the client (and investment firm) is/are not confronted by any nasty financial surprises.

²³ Dealing with several objectives, paragraph 3.2.2, p.15.

4. Special themes

4.1 Suitability assessment in 'and/or' situations

When it comes to collecting information within the framework of the 'Know Your Customer' principle and the adequate execution of the suitability assessment on that basis, a number of special situations can arise.

One example is determining the investment profile of the account to which a 'joint account' situation applies. Can this be determined and signed for by one of the account holders, or should it be done jointly? First and foremost it is important to clarify the legal framework relating to joint accounts.

In practice the 'joint account' phenomenon is used fairly frequently, for example in the form of current and investment accounts at banks. A 'joint account' should, in fact, be regarded as a special kind of shared account. Whenever we refer to a 'joint account', what we mean is the shared account to which the account holders have access jointly and individually. In addition to this there are the 'ordinary' shared accounts which are not referred to as joint accounts, in other words an 'account requiring dual authorisation', although this is much less common than the 'joint' variant. Incidentally, from a legal perspective fewer special complicating factors apply in this instance. After all, all account holders have to give their permission before trading can commence. The 'joint' variant is often used by spouses or (cohabiting) partners. In their case the 'joint' variant is used as an alternative for the mutual granting of a power of attorney. Wherever a power of attorney ends, in principle, upon the death of a constituent party of a power of attorney, the rights of the holder of a 'joint' account will transfer

to the heirs. For example the Dutch Civil Code assumes a mutual obligation based on the community which implies that actions relating to the community of property can only be performed by the participants jointly. Individual 'joint' account holders must, for example, be regarded as authorised to perform transfers which can be qualified as 'enjoyment', 'use' or 'administration'. It should be noted that this applies to administrative actions which serve the 'ordinary maintenance' or the 'retention of the community property'.

This raises the question of what is covered by the scope of the definition of 'ordinary maintenance'. This covers all actions which are intended for 'normal use', including all actions which can usefully serve normal use of the property, as well as the acceptance of performances owed to the community. This will, in many cases, also include the (regular) execution of investment transactions by individuals account holders. The investment account must, however, continue to function as initially intended by the account holders, when entering into the agreement. For example, this does not include opening or closing the account.

With regard to the agreed investment profile, one comment needs to be made with regard to joint accounts. Article 54 (6) of the delegated regulation now provides a legal basis which provides guidance for investment firms as regards dealing with the joint account situation. The article referred to states that the investment firm must have a policy which stipulates who, in a joint account situation, is subject to the suitability assessment. In other words from which client(s) information regarding knowledge and experience, financial position and investment goal must be obtained. Although investment firms now

have a certain basis to fall back on, it is still unclear how all kinds of situations encountered in practice should be resolved. In the situation in which a natural person is represented by another natural person, Article 54 (6) of the delegated regulation determines that the financial position and investment goal of the underlying client, so not of the representative, are important. However, the knowledge and experience of the representative are important. Under MiFID II it is determined that this will be that of the representative of the natural person or the person authorized to carry out transactions on behalf of the underlying client. If, when concluding the agreement with the investment firm, a joint decision was taken to opt for a defensive profile, a limited adaptation of the profile (e.g. moderately defensive profile) would still be justified. However, if the risk profile of the agreed investments is substantially increased, a case can be made that this no longer can be regarded as 'normal use'. The above certainly applies if a residual debt could arise due to trading in derivatives. This category problems does not only end with the issue relating to the assets. In one of its guidelines ESMA gives further clarification of the applicability of Article 19(4) of the MiFID and Articles 35 and 37 of the MiFID Implementing Directive. This guideline²⁴ describes the problem of obtaining investment knowledge and experience from the various account holders in the event of a joint account. In its guideline ESMA states the following about this situation²⁵: *"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"*.

²⁴ Guidelines on certain aspects of the MiFID suitability requirements' by ESMA, 21 August 2012/387.

²⁵ Guidelines on certain aspects of the MiFID suitability requirements' by ESMA, 21 August 2012/387; paragraphs 51 and 52, p.11.

In many cases there is no suitable legal framework. In practice it transpires that one of the account holders considers itself, rightly or wrongly, more skilled than the other account holder being able to take investment decisions. This is based on previous education, (work) experience, interest or availability of time, or a combination of these factors. When obtaining information the investment knowledge and experience of one of the account holders is usually noted. This is often the party that supposedly has the most knowledge and/or experience. However, the other account holder, with possibly less investment knowledge and/or experience, can also contact the investment firm. As regards to investment advice this may be the order to purchase or sell an financial instrument. If the agreement with the investment firm relates to portfolio management, it is not inconceivable that the notification will relate to a change of the investment profile.²⁶ In many cases there will be no, or insufficient, information available of the investment knowledge and experience of the person in question. This may make it impossible to carry out the suitability assessment correctly.

In its guideline, ESMA states the following with regard to this undesirable situation²⁷: *“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”*.

ESMA does not provide an answer to the issue regarding which existing financial situation and investment goals have to be considered in the case of a joint account. What, for example, should the response be to situations in which there is a ‘joint’ account, but the account holders are married on the basis of a prenuptial agreement? With regard to the obtaining of information within the framework of ‘Know Your Customer’ principle (4:23 of the Financial Supervision Act) the question arises as to how and whose financial position must be established. Should only the joint assets be considered in order to eventually specify an investment profile? Or should the individual assets (or the lack thereof) be considered? The above situation primarily refers only to a pre-transactional suitability assessment. When assessing the suitability of the service all the information of the two clients/account holders involved will have to be obtained in the event of a joint account in order to determine the suitability of the service.

In the event of an administration order, forced administration or simply a power of attorney, the EMSA guidance makes it clear that the financial situation and the investment objective(s) which relate to the natural person (or a small entity) must be obtained and considered.²⁸

It is therefore worth recommending taking the following measures:

1. The investment knowledge and/or experience must be obtained from all account holders. This must be used ex ante for the suitability of the service, because the choice for the service can be fundamental to the feasibility of the joint financial objectives.
2. The investment firm must inform the clients ex ante that only the investment knowledge and experience of the account holder with whom the investment firm maintains contact will be used to assess the suitability of the investment transactions.

3. With regard to the periodic reporting on the developments of the investment portfolio(s) the communication must be attuned to the person who has the least investment knowledge and/or experience.
4. It is worth recommending arranging a periodic review of the investment portfolio(s) in the presence of all account holders. Minutes should be drawn up of this review and stored in the (digital) dossier.

With regard to the scope of the financial position and nature of the investment objective(s), the investment firm will once again have to indicate in writing how this should be responded to. In the case of separate assets a record will have to be made ex ante of whether these are or are not to be considered for the suitability. We also wish to point out paragraph 3.3 (calculating the maximum loss capacity).

4.2 Suitability assessment in the case of legal entities

With regard to the suitability assessment for the investments for legal entities some challenges similar to those described above will have to be faced. In this context, legal entities mean, among others, smaller companies (such as pension firms), foundations and associations. These business relationships can lead to the use of a ‘joint’ bank account. For example, the partners in a private company with limited liability may decide to use one or more ‘joint’ accounts. In addition, powers of attorney are often granted on the accounts of legal entities.

In the event that the representatives of a legal entity decide to use investment services, the question will quickly arise as to how the suitability assessment should be performed. After all, a legal entity will not possess an emotional risk appetite or investment knowledge and experience. This will have to be assessed in conjunction

²⁶ It is very likely that this will no longer be regarded as ‘normal use’, meaning that the permission of both account holders will be required.

²⁷ Guidelines on certain aspects of the MiFID suitability requirements by ESMA, 21 August 2012/387; paragraph 52, p.11.

²⁸ Guidelines on certain aspects of the MiFID suitability requirements by ESMA, 21 August 2012/38; paragraph 53, p.12: “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.

with the natural persons who represent the legal entity vis-à-vis the investment firm. On the other hand, information about the total financial position, the investment horizon, the objective(s) and the financial risk appetite can, of course, be obtained from a legal entity. It is also possible that the financial position of a legal entity will affect the financial position of a natural person. Examples are the private pension company and its director and principle shareholder/person entitled to a pension. How should these situations be dealt with?

As explained in paragraph 2, ESMA has adopted the position that information on the investment knowledge and experience of the representative of the entity must be obtained. Although the ESMA guideline does not show that this also applies to the emotional risk appetite; this can be assumed. What should be done in the situation that there are several representatives (for example the board of a foundation)? In that circumstance, by analogy with the ESMA guideline, the investment knowledge and experience of those natural persons that maintain contact on the investments/investment service(s) with the investment firm, and who are entitled to carry transactions, must be assessed. However, in the event that this/these representative(s) is/are unable - temporarily or otherwise - to maintain contacts with the investment firm, the investment firm will have to re-assess. In concrete terms this means that the investment knowledge and experience of the 'new' contact people will have to be assessed. This requires prudence on the part of the investment firm and also affects procedures and systems within the investment firm.

Another question is what should be done in the situation in which a natural person is becoming a client of an investment firm and this person is also director and principle shareholder of a legal entity? The answer to this is that, while obtaining information regarding the natural person, the financial position of the legal entity/entities with direct links to the natural person must be taken into account.

Information must be obtained on behalf of a natural person that would like to make use of an investment service (investment advice or portfolio management). The pension situation of this natural person also needs to be analysed. The person has a private company with limited liability for the pension. In order to obtain as complete a picture as possible of the natural person's financial situation, the financial situation of the company must also be considered. The reverse is not the case. If an account is opened for the private company with limited liability in order to manage (or advice on) funds, the financial position of the director and principle shareholder is of secondary importance. The company has its own financial position and financial objective which has to be pursued.



5. What investment firms should be doing now

5.1 Define operational impact and strategic choices

The main focus of MiFID II is on investor protection. The additional side-effect of implementing MiFID II will be 'efficiency'.

For example, increased reporting requirements in current legacy systems will force investment firms to reconsider and possibly transform their (reporting) systems. If legacy systems are retained, operational costs and the cost of compliance will bring further pressure to bear on the cost/income ratios.

What is more, increased suitability and appropriateness demands will require a different approach to data gathering and providing investments services clients. This could, in the future, lead to integrated systems and advanced and predictive customer analytics based on static and dynamic data. However, at this stage and in the near future, the expectation is that investment firms will reduce complexity in current legacy way-of-working rather than facilitate complexity with advanced tooling. This might bring pressure to bear on profitability of investment firms as well, because of a lack of innovation.

These indirect financial implications will force investment firms to operate more efficiently, whether in legacy systems (short-term), or completely renewed processes, systems, etc. (long-term). This will have a fundamental impact on the current operations and advisory processes of investment firms.

All investment firms are impacted by MiFID II. Consequently each investment firm will make strategic choices as to how to stay

relevant to their clients in a sustainable (and profitable) way. A sound balance between what is required by legislation (MiFID II) and what is feasible in the long run is needed in order to implement MiFID II in a sustainable way. Balanced legal requirements and operational implications could translate into competitive advantages.

It might be worthwhile to redesign the following operating elements in order to effectuate these advantages:

- Product range, product governance, product and review approval process;
- Distribution strategies (country strategy, distribution partners, services to different client segments, etc.);
- Costs and charges (re-design of cost allocation (including pay for research), transparency, etc.);
- Third-party strategy and rationalisations (e.g. brokers, fund managers, etc.).

Investment firms should also be reflecting on how they can use the increased data available under MiFID II to benefit their business and MiFID II as a catalyst to ensure their data infrastructure is flexible and efficient.

It will also be important for firms to have multiple distribution channels and robust links with distributors, including innovative distribution models such as online, mobile and social media.

With the 3 January 2018 deadline rapidly approaching, and implementation programmes well under way, there is no time to wait as regards taking the necessary strategic decisions. In order to be market-leading, investment firms cannot afford to focus only on implementation and

compliance, but instead on wider market and regulatory considerations.

5.2 Investigate other services concepts

5.2.1 New service concepts

For a long time now a discussion has been going on about initiating a hybrid form of advice somewhere between execution only and advice, in addition to the traditional service concepts of portfolio management, investment advice and execution only. The reason for this is simply that not all clients are equal and that, due to a ban on commission, clients are receiving less and less advice because they are unable and/or unwilling to pay. In times in which self-reliance is becoming more and more important, there is a need for a certain degree of supervision. Supervisors in, among others, the Netherlands and the United Kingdom confess witnessing a reduction in the range of services. They are trying to convince the financial sector to offer new service concepts. Examples and terms being suggested are 'execution only plus', 'execution only with guidance', 'simplified advice', 'automated advice', etc. In the context of these new service concepts it continues to be important that the client is properly informed about investment possibilities and risks and is increasingly able to take investment decisions independently.

An important element in this discussion is that, above all, the focus must be on the client's interest. The level of assessment should and may not be reduced. The question is, however, which service ought to be the legal point of departure. Often, a complete 'Know Your Customer' principle

is not feasible from a cost perspective. Information technology may therefore be a good way to respond and make the collection of data more efficient.

5.2.2 Special types of investment advice

We will now highlight two major themes in the discussion of various service concepts, namely concepts which are on the interface between execution only advice and automated advice. 'Advice' is considered automated²⁹ if:

- an algorithm output is generated using the input from a client;
- a tool is used directly by the client, without (or with limited) intervention by the adviser;
- the output of the tool can be described as 'advice'.

In different countries we see that risk profiling processes are improving. At the moment, although Robo advice platforms are based on very simple processes, advanced processes are also emerging, as encouraged by regulators.

Robo platforms offer risk profiling processes for one portfolio with one account. The next level is to support clients with a more holistic approach of the financial situation of the client with multiple goals and multiple accounts with the possibility to interact with advisors in an omni-channel environment.

If advice is given, the extent to which client information is obtained is important. In the case of automated advice this is no different to advice provided by an adviser. In both instances, automated and via the adviser, suitability and appropriateness requirements will have to be fulfilled.

In order to support investment firms with the detailed implementation of the intermediate forms the English regulator, the FCA, offers a series of example scenarios in its publication on 'Retail Investment Advice' which offer guidance for determining the extent of the advice.³⁰ The FCA often adopts a pioneering role as

regards defining the intermediate forms of advice. In addition, the Joint Committee Discussion Paper on automation in financial advice of EBA, EIOPA and ESMA provides more clarity on the possibilities. In particular, investment firms in the United Kingdom take account of these intermediate forms, the definitions and the legal effects thereof when implementing Robo advice propositions. MiFID II therefore ought to be a robust component of any Robo advice proposition/implementation.

As regards investment firms that still have to make the step towards Robo advice or automated advice, it is advisable to adhere closely to these proposed scenarios when determining the extent of the advice and the corresponding regulations. It is likely that other regulators will follow the positions adopted by the FCA, EBA, EIOPA and ESMA.

The practice of serving clients using intermediate forms of advice is going to be implemented more broadly in the near future. If investment firms implement these intermediate forms on the basis of client need, this will have a significant chance of success.

5.3 Implement regulation smart - align MiFID II with other regulations

Investment firms are faced with an array of regulatory measures that need to be considered in conjunction with MiFID II. These include more than the following provisions which focus primarily on investment management:

- **UCITS:** Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions in relation to undertakings for collective investment in transferable securities (UCITS) as regards depository functions, remuneration policies and sanctions.

- **AIFMD:** Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 10160/2009 and (EU) No 1095/2010.
- **PRIIPS:** Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPS).
- **IDD:** Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

Wider international initiatives also need to be considered, including possible implications of a Financial Transaction Tax and measures taken on the basis of other jurisdictions, such as Volcker and FATCA.

Earlier changes in national regulations will potentially interact with MiFID II. In Belgium, for instance, agreements have been reached between the regulator and banks in relation to the limitation of the marketing of complex products. In the United Kingdom the Retail Distribution Review (RDR) is implementing many of the MiFID II requirements on the ban on inducements. The Netherlands already introduced such a ban in 2013.

Given the sheer number of ongoing regulatory initiatives that overlap in key areas, it is inefficient to look at their implications independently. It is preferable to identify all relevant regulations and determine commonalities and overlapping themes. This will ensure a more cost-effective implementation of the requirements, because it will reduce the amount of duplication of work in overlapping areas.

²⁹ EBA, EIOPA and ESMA - Joint Committee Discussion Paper on automation in financial advice, 2015 (p. 12, 13).

³⁰ www.fca.org.uk/static/documents/finalised-guidance/fg15-01.pdf.

Appendices

Appendix 1: about the authors



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Appendix 2: Glossary

A number of terms are used in this white paper. Although the explanation is given in the text, we have compiled a list of the most commonly used acronyms for your ease of reference.

AFM

Authority for the Financial Markets. The Dutch supervisory authority for the financial markets.

AIFMD

Alternative Investment Fund Managers Directive. EU law on the financial regulation of hedge funds, private equity, real estate funds, and other 'Alternative Investment Fund Managers' (AIFMs) in the European Union.

Client profile

Information regarding the financial position, the experience with investments and the investment goals. The point of departure when drawing up and establishing the client profile is that the investment firm must act in the interest of its client and, partly for that reason, must be conversant with the client profile.

EBA

European Banking Authority. Independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector.

EIOPA

European Insurance and Occupational Pensions Authority. Independent EU Authority whose core responsibilities are to support the stability of the financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries.

ESMA

European Securities and Markets Authority. Independent EU Authority enhancing the protection of investors and promoting stable and orderly financial markets.

FATCA

Foreign Account Tax Compliance Act. FATCA targets tax non-compliance by U.S. taxpayers with foreign accounts.

FCA

Financial Conduct Authority. The conduct and prudential regulator for financial services in the United Kingdom.

Fund

A fund is a group of, for example, shares or bonds of various companies. Whenever investments are made in funds, the contribution is actually spread across all these companies.

Investment or risk profile

Banks use a wide range of terms, with 'investment profile' and 'risk profile' being used interchangeably. These profile names indicate which investment risk a client is emotionally and financially able and willing to run. This profile shows what the relationship is between the risk that a client wants to take and the expected return. Such a profile can vary from very defensive to very offensive.

UCITS

Undertakings for Collective Investment in Transferable Securities. These are investment funds regulated at European Union level.

PRIIPS

Packaged retail and insurance-based investment products.

RDR

Retail Distribution Review. Initiative of the FCA in order to raise professional standards in the financial industry, introducing greater clarity between the different types of service and make the charges associated with advice and services more clear.

Securities

A collective name for securities which represent a company. Examples are a share or bond. Derived products are also referred to as derivatives.

Wft

'Wet op het financieel toezicht', the Financial Supervision Act. This brings together a large number of rules and regulations for the financial markets and the supervision thereof.



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