Questions and Answers

On MiFID II and MiFIR investor protection topics

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Acronyms and definitions used

ESMA	The European Markets and Securities Authority
ITS	Implementing Technical Standards
MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and of the Council
MiFID II	Markets in Financial Instruments Directive (recast) – Directive 2014/65/EU of the European Parliament and of the Council
MiFIR	Markets in Financial Instruments Regulation – Regulation 600/2014 of the European Parliament and of the Council
MTF	Multilateral Trading Facility
OTC	Over The Counter
OTF	Organised Trading Facility
Q&A	Question and Answer
RPA	Research Payment Account
RTS	Regulatory Technical Standards

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[1] RTS 27 refers to the regulatory technical standards under Article 27(10)(a) of MiFID II adopted by the EC on 08/06/2016, C(2016) 3333/4.
[2] RTS 28 refers to the regulatory technical standards under Article 27(10)(b) of MiFID II adopted by the EC on adopted by the EC on 08/07/2016, C(2016) 3333/3.

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Introduction

Background

The final legislative texts of Directive 2014/65/EU[3] (MiFID II) and Regulation (EU) No 600/2014[4] (MiFIR) were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. The two texts were published in the Official Journal on 12 June 2014 and entered into force on the twentieth day following this publication – i.e. 2 July 2014.

Many of the obligations under MiFID II and MiFIR were further specified in the Commission Delegated Directive[5] and two Commission Delegated Regulations[6] [7], as well as regulatory and implementing technical standards developed by the European Securities and Markets Authority (ESMA).

MiFID II and MiFIR, together with the Commission delegated acts as well as regulatory and implementing technical standards will be applicable from 3 January 2018.

Purpose

The purpose of this document is to promote common supervisory approaches and practices in the application of MiFID II and MiFIR in relation to investor protection topics. It provides responses to questions posed by the general public, market participants and competent authorities in relation to the practical application of MiFID II and MiFIR.

The content of this document is aimed at competent authorities and firms by providing clarity on the application of the MiFID II and MiFIR requirements.

The content of this document is not exhaustive and it does not constitute new policy.

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[3] 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.

[4] 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) N0 648/2012.

[5] Commission Delegated Directive of 7.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. The Commission Delegated Directive was published on 7 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

[6] Commission Delegated Regulation of 25.4.2016 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 purposes of that Directive. The Commission Delegated Regulation was published on 25 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

[7] Commission Delegated Regulation of 18.5.2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions. The Commission Delegated Regulation was published on 18 May 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 50 of MiFIR.

Status

The question and answer (Q&A) mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation[8].

Due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if Q&As are not formally consulted on, ESMA may check them with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group or, where specific expertise is needed, with other external parties.

ESMA will periodically review these Q&As on a regular basis to update them where required and to identify if, in a certain area, there is a need to convert some of the material into ESMA Guidelines and recommendations. In such cases, the procedures foreseen under Article 16 of the ESMA Regulation will be followed.

Questions and answers

This document is intended to be continually edited and updated as and when new questions are received. The date on which each section was last amended is included for ease of reference.

[8] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a Europe-an Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.

1 Best execution [Last update: 16 December 2016]

Question 1 **[Last update: 10 October 2016]**

How should firms and competent authorities understand the difference between "reasonable steps" and "sufficient steps"?

Answer 1

MiFID I required firms to "*take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order*". MiFID II now instead requires firms to "*take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order*".

Whilst firms remain subject to the same overarching obligation to obtain the best possible results on a consistent basis when executing client orders, the requirement for "sufficient" steps sets a higher bar for compliance than "reasonable" steps.

When designing their execution policies and establishing their execution arrangements, firms will have to ensure that the intended outcomes can be successfully achieved on an on-going basis. This is likely to involve the strengthening of front-office accountability and systems and controls according to which firms will ensure that their detection capabilities are able to identify any potential deficiencies. This will require firms to monitor not only the execution quality obtained but also the quality and appropriateness of their execution arrangements and policies on an ex-ante and ex-post basis to identify circumstances under which changes may be appropriate. An example of ex-ante monitoring would be to ensure that the design and review process of policies is appropriate and takes into account new services or products offered by the firms. Accordingly, an ex-post monitoring may be to check whether the firm has correctly applied its execution policy and if client instructions and preferences are effectively passed along the entire execution chain when using smart orders routers or any other means of execution.

Firms' processes might involve some combination of front office and compliance monitoring and could use systems that rely on random sampling or exception reporting.

There should be channels in place to ensure that the results of ongoing execution monitoring are escalated to senior management and/or relevant committees, and fed back into execution policies and arrangements to drive improvements in the firm's processes.

This overarching requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion. Rather, firms will need to verify on an on-going basis that their execution arrangements work well throughout the different stages of the order execution process. ESMA expects firms to take all appropriate remedial actions if any deficiencies are detected so that they can properly demonstrate that they have taken “all sufficient steps” to achieve the best possible results for their clients.

Question 2 [Last update: 10 October 2016]

What is meant by checking the fairness of the price proposed to the client when executing orders or decisions to deal in OTC products?

Answer 2

MiFID II strengthens the existing best execution standard in relation to OTC[9] products. In this regard, Article 64 of the MiFID II Delegated Regulation requires firms to check the fairness of the price proposed to the client when executing orders or taking decisions to deal in OTC products, including bespoke products, by gathering market data used in the estimation of the price of such products and, where possible, by comparing with similar or comparable products.

Firms, as a matter of practice, may be routinely taking account of external market data and externally verifiable reference prices (where available), when pricing or checking the price of OTC products (including bespoke instruments), in fulfilling their best execution obligations. However, MiFID II now imposes an explicit requirement on firms to ensure that such checks are undertaken on a systematic basis and embedded in their policies and practices. As a consequence, firms need to ensure that they have the necessary procedures and arrangements in place as well as appropriate valuation systems. With greater access to technology and data analytics, firms will be expected to scrutinise the methodologies and inputs underpinning any valuation processes and pricing models utilised with respect to OTC products in order to ensure that they are consistently checking the fairness of the price. Similarly, when placing orders resulting from decisions to deal in OTC products, firms will be expected to undertake the necessary checks on the fairness of the price and ensure that it is reflected in their arrangements.

This is an ex-ante assessment by the firm that takes place prior to the execution of the order. However, there is an expectation that any pre-trade checks or processes would be included in the firm’s review and monitoring of its best execution arrangements. Firms would therefore need to have records, documentation in place, to evidence this as part of their ongoing monitoring of best execution.

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[9] For the purposes of this Q&A, a financial instrument is an Over The Counter or OTC product when it is: (i) not admitted to trading, or, (ii) not traded on a trading venue (i.e. a regulated market, an MTF or OTF).

The aim is for firms to be able to justify their pricing decisions, and have systems in place to ensure that any judgements or decisions are taken with the clients' best interests in mind and are not biased by conflicts of interest.

We expect that any checks or controls will be calibrated according to the nature of the financial instrument and the characteristics and circumstances of the individual trade.

Question 3 [Last update: 16 December 2016]

Where firms use a single venue, how can they evidence that this has allowed them to obtain best execution?

Answer 3

MIFID II does not prohibit firms from selecting only one execution venue to execute client orders in a given class of financial instruments where they are able to demonstrate that such a choice enables them to consistently get the best results for their clients. Since MiFID I was implemented there has been a sharp proliferation of execution venues leading to an increased fragmentation of the market. ESMA expects firms to be aware of the evolving competitive landscape in the market for execution venues operators and therefore to take into consideration the emergence of new players, new venues functionalities or execution services to determine whether or not any of these factors would support to include only one execution venue in their execution policy.

In order to comply with the requirement under Article 24(1) of MiFID II to act in the best interests of its clients, firms will need to regularly assess the market landscape to determine whether or not there are alternative venues that they could use. This assessment will benefit from the new metrics available under RTS 27 and from any other relevant source of data. In particular, the reports generated pursuant to that RTS shall give firms information on trading conditions and quality of execution across different execution venues through a series of metrics such as volume, frequency of trading, resilience or execution price related information. The MIFID II Delegated Regulation sets out specific requirements relating to the content of the execution policy. According to this, firms have to include a list of the venues that the firm ordinarily uses, as well as a list of the quantitative and qualitative factors used to select the execution venues on that list.

Such an exercise involves a number of different actions. Specific analysis must be carried out to determine whether or not other suitable venues exist. In doing so, a firm may, for instance, benchmark the value of expected aggregate price improvements by adding a venue and comparing the expected outcomes against an assessment of any additional direct, indirect or implicit costs (to the extent that such costs would be directly or indirectly passed on to clients), counterparty or operational risks.

Finally, using a single venue should not lead firms to be "over-reliant" on the single venue. Using a single venue does not diminish a firm's responsibility to monitor the quality of execution. Nor does it mean that merely executing client orders on that venue will allow the firm to discharge its best execution obligations. When using only a single venue, the specific way that the firm executes the order may be just as important in achieving best execution. Indeed, sending an order to be executed on the central order book using different order types (e.g. limit orders, fill or kill 'FOK', peg order, good till cancelled 'GTC'), executing the order using a pre-trade waiver, or executing the order at a closing or opening auction may result in materially different outcomes. Different outcomes may also stem from the way in which Smart Order Routers and/or algorithms are calibrated. Similarly, entering an order in one block, versus splitting it into multiple child orders, may have a very different market impact and thus directly affect the cost to the client.

Also, in order to comply with the requirement under Article 24(1) to act in the best interests of its clients, a firm should consider transmitting client orders instead of executing them itself where that would deliver a better result for clients, provided the firm is authorised for reception and transmission of such orders.

Similar analysis and assessments should be undertaken by portfolio managers or receivers and transmitters of orders that intend to send orders to a single entity for execution.

Question 4 [Last update: 16 December 2016]

Where execution venues and firms publish reports as required under RTS 27 and 28, how long should the reports be kept in the public domain and freely accessible?

Answer 4

The information published under RTS 27 is intended to provide the public and firms with relevant data to measure the quality of execution. These objectives are particularly important as the MIFID II Delegated Regulation requires, amongst other things, that firms assess whether the list of venues they ordinarily use for execution should be updated following a material change at a particular venue. ESMA considers that to achieve these outcomes, it is appropriate for execution venues to keep each report available in the public domain for a minimum period of two years.

RTS 28 is intended to enable the public and investors to evaluate the quality of a firm's execution practices by requiring publication of valuable information about how and where the firm has executed client orders. It is important that these reports allow for a robust comparison between different firms and also to enable comparison of performance over time. Therefore, ESMA considers it suitable for firms to keep each report available in the public domain for a minimum period of two years.

Question 5 **[Last update: 16 December 2016]**

What is the latest date after year-end by which firms executing or transmitting client orders, or portfolio managers, should publish the report showing their top five execution venues or firms where they have sent client orders and information about the quality of the execution they obtained?

Answer 5

Reports published under RTS 28 or Article 65(5) of the MiFID II Delegated Regulation are intended to provide the public with valuable data that will diminish information asymmetries and help investors select the firms they want to work with. To ensure those investors have up-to-date information, ESMA considers it suitable that the reports should be made public on or before the 30th of April following the end of the period to which the report relates.

Question 6 **[Last update: 16 December 2016]**

How soon after MiFID II comes into effect will venues and firms have to publish RTS 27 and 28 reports?

Answer 6

The data firms are required to collect and publish under RTS 27 are tied to several provisions stemming from MiFID II and MiFIR, such as the 'Size Specific to The Instrument' (SSTI) thresholds under the transparency regime and the transaction reporting requirements. ESMA therefore considers that the first report published under RTS 27 should cover a reporting period that is representative of the first quarter following the date on which the legislation enters into force.

The information that firms will be required to publish under RTS 28 is of a different nature. Along with the report on the top five venues where they have executed their client orders, it requires a summary of the outcomes achieved by firms when executing those orders. As best execution is not a new requirement under MiFID II, firms should already have implemented most of the necessary arrangements to conduct this analysis.

Therefore, ESMA considers that firms should release the first annual report under RTS 28 by the end of the fourth month of the calendar year during which the legislation enters into force.

As a practical matter, this might mean that the first year's report may lack some of the detail that would be available for subsequent reports, given that firms may not yet have a whole year of data published under RTS 27. Nonetheless, information on the top five venues and a summary of the outcomes achieved, such as it is, will still provide useful information to investors.

Question 7 **[Last update: 16 December 2016]**

If a firm provides both the services of order execution and transmission of orders to other firms (i.e. to a third party for execution), will they need to produce two sets of top-five reports, or will a single, consolidated report suffice?

Answer 7

For a given class of financial instruments, there may be many instances where the firm provides both services. If the firm is not a member of all trading venues where client orders need to be routed for execution, the firm will need to transmit some orders to other firms for execution alongside its execution activity as member of trading venues. It may also elect to use a broker instead of directly executing orders on an execution venue to minimise market impact and achieve a better outcome for the client.

ESMA considers that where firms provide both the services of order execution and reception and transmission of orders, they will need to provide two separate reports in relation to these services. It is important that these reports are distinct so that, investment firms disclose on one hand the top five execution venues and on the other hand the top five entities (brokers) to which client orders were routed during the relevant period. To note, this does not preclude firms from, in addition, providing a single consolidated report on the execution venues and entities the firms uses most frequently to execute client orders.

Question 8 **[Last update: 16 December 2016]**

How should the RTS 27 and RTS 28 reports be made available to the public?

Answer 8

Execution venues and firms are required to make the RTS 27 and 28 reports available to the public, without any charges, in a machine-readable electronic format.

In order to ensure that such reports are in the public domain and freely accessible, firms can publish these reports on their respective websites in an easily identifiable location on a page without any access limitations. ESMA notes that these reports should not be placed behind a firewall, registration page or be subject to password encryption or other restrictions.

No particular formatting standard is prescribed unlike some other reporting obligations in MiFID II which specify a common XML standard (typically for regulatory submissions). The readability and comprehensibility of these reports is however crucial given that their purpose is to provide the public with relevant data on execution quality.

Question 9 [Last update: 16 December 2016]

Where RTS 27 (Article 5) requires a venue to disclose costs, can this report be aggregated and presented as venue-level information?

Answer 9

Article 27(3) of MiFID II requires that execution venues (regulated markets, MTFs, OTFs, SIs, market makers and other liquidity providers) make information on the quality of execution available to the public in relation to price, costs, speed and likelihood of execution for individual financial instruments. Consequently, Article 5 of RTS 27 requires venues to publish for each financial instrument quarterly information on the costs applied by the venue to its members or users.

It is worth clarifying that venues are expected to provide information on costs aggregated at the level of the venue and any market segment(s) they operate (e.g. standard, high growth, dark book, lit book etc.). This approach is supported by Recital 4 of RTS 27 which provides that to avoid inappropriate comparison between execution venues and to ensure the relevance of collected data, execution venues should submit separate reports corresponding to segments that operate different order books or that are regulated differently or use different market segment identifiers. In addition, it may be relevant to differentiate cost information in relation to the business model or fee structure of the venue e.g. where venues apply different fees depending on the type of client or member e.g. maker taker fee models. In this way, venues should ensure that cost information is consolidated at the appropriate level so as to facilitate comparability between other execution venues.

Question 10 [Last update: 16 December 2016]

Where RTS 28 Article 3(3) requires a summary of the analysis and conclusions from a firm's execution monitoring, does this require a separate summary for each class of financial instruments, or would it suffice to provide a consolidated summary covering all classes of financial instruments?

Answer 10

Firms are expected to provide a summary of the analysis and conclusions they draw from their detailed monitoring of execution quality in relation to each class of financial instrument. The aim is to provide clients with meaningful information in order to effectively assess and scrutinise the execution quality achieved by the firm during the year. This will enable clients to evaluate the firm's execution practices and compliance with its execution policy. It is worth noting that Recital 15 of RTS 28 clarifies that firms may provide more granular reporting in addition to the reporting requirements specified in RTS 28.

Differentiating such information according to class of instrument is particularly relevant given that execution quality could vary since a firm may employ different execution methods (e.g.

different venues, execution strategies, or order routing practices) depending on the nature of the financial instrument. Providing a summary according to class of financial instrument also corresponds with the requirement to report on the top five entities used for the execution, placing or transmission of client orders, which also relates to each class of financial instrument (please see Q&A7).

While the summary of the analysis and conclusions drawn from firms' execution monitoring is required for each class of financial instrument, some of the information to be disclosed in the summary (as set out in clauses a – h of Article 3(3)) may be provided on a consolidated basis where such information is common to several or all classes of financial instruments. In this regard, information on close links, conflicts or common ownership as well as information on payments, rebates and benefits of venues may be disclosed on a consolidated basis, where such information is common across several or all classes of financial instruments.

2 Suitability and appropriateness [Last update: 16 December 2016]

Question 1 [Last update: 10 October 2016]

Does the suitability report only have to be provided if the investment advice leads to a transaction?

Answer 1

No. A suitability report must be provided to a retail client when that client has been provided with investment advice, regardless of whether or not the advice is followed by a transaction.

According to the second subparagraph of Article 25(6) of MiFID II, the firm shall, when providing investment advice, before the transaction is made, provide the client with a statement on suitability in a durable medium specifying the advice given and how that advice meets the preferences, objectives and other characteristics of the retail client.

Article 54(12) of the MiFID II Delegated Regulation states that firms shall provide a suitability report when providing investment advice. The report shall, *inter alia*, include an outline of the advice given and how the recommendation is suitable for the retail client.

By outlining that the report shall be given when providing investment advice, the implementing measures clarify that the suitability report has to be provided to the client irrespective of whether or not the advice is followed by a transaction. In fact, investment advice, as defined in Article 4(2)(4) of MiFID II does not require a recommendation to be followed by a transaction.

The wording in MiFID "before the transaction is made", is therefore a clarification of when the report has to be provided, but does not mean that the advice has to be followed by a transaction.

This is line with the purpose of the second subparagraph of Article 25(6) of MiFID II that states that the suitability report serves the purpose of proving whether the recommendation given was in fact suitable for the client.

Question 2 [Last update: 10 October 2016]

Shall the suitability report contain the record of when the investment advice is given to the client?

Answer 2

Yes. The suitability report should contain the date and time of the day when the advice was given to the client. Firms should also keep a record of the date and time when the suitability report was provided to the client (if these dates differ, as may be the case when the interaction with the client occurs through a means of distance communication).

Finally, firms must keep the respective suitability report according to MiFID II record keeping requirements.

To fulfil these reporting and documentation requirements, it may be useful to timestamp the suitability reports. However, if firms comply with the above in any other way, a timestamp may not be necessary.

Question 3 [Last update: 10 October 2016]

Can the suitability report be made available to the client on the firm's website, with the client receiving a notification (via email or through any other means of communication) regarding the availability of this document?

Answer 3

Yes. According to Article 25(6) MiFID II, the suitability report has to be provided in a durable medium. In this regard, Recital 82 of MiFID II clarifies that a durable medium may also be in an electronic form. Websites and other media in electronic form are therefore not excluded so long as they fulfil the definition of 'durable medium' as set out in Article 4(1) point 62 of MiFID II and the requirements set out in Article 3 of the MiFID II Delegated Regulation.

Therefore, the suitability report can be made available to the client in a secured area of the firm's website, specifically dedicated to that client, with the client receiving a notification (via e-mail or through any other means of communication) of the availability of the document on the website, provided that the choice of that medium is compliant with MiFID II relevant requirements. In particular, it should be consistent with the type of interaction with the client (for example, if the interaction occurs through the telephone or another means of distance communication) and the client has to give his/her consent.

Question 4 [Last update: 10 October 2016]

Can the suitability report be sent together with the report due when carrying out an order on behalf of a client other than for portfolio management?

Answer 4

According to Article 25(6) MiFID II, the suitability report has to be provided to the client before the transaction is made. Therefore, it cannot be sent together with the report that is due when carrying out an order on behalf of a client, which has to be provided after the order was carried out.

Different requirements apply in situations described in the third subparagraph of Article 25(6) of MiFID II (i.e. when the agreement is concluded using a means of distance communication)

In these cases the suitability report could be sent together with the report about the transaction, but without undue delay and all the relevant requirements have to be fulfilled.

Question 5 [Last update: 10 October 2016]

Shall a suitability report be provided to the client when the advice given is not to buy or sell a financial instrument?

Answer 5

Yes. Firms providing investment advice are required to always provide the client with a suitability report, irrespective of the specific recommendation given, including the advice not to buy, hold or sell a financial instrument.

In this regard, Recital 87 of the MiFID II Delegated Regulation specifically clarifies that *"investment firms should undertake a suitability assessment not only in relation to* [when] *recommendations to buy a financial instrument are made but for all decisions whether to trade including whether or not to buy, hold or sell an investment"*.

Question 6 [Last update: 10 October 2016]

What are the obligations on a firm when a specific financial instrument is unsuitable for a client, in particular also in situations when the client wishes to proceed with the transaction nonetheless?

Answer 6

When providing investment advice, firms are required under Article 25(2) of MiFID II to recommend to the client (or potential client) only the investment services and financial instruments that are suitable for him/her and, in particular, are in accordance with his risk tolerance and ability to bear losses. Recital 87 of the MiFID II Delegated Regulation clarifies that a suitability assessment should be undertaken "*not only in relation to* [when] *recommendations to buy a financial instrument are made but for all decisions whether to trade including whether or not to buy, hold or sell an investment"*.

Therefore, firms should avoid any behaviour that might result in a breach of the rules on suitability. Examples of clearly incorrect behaviours (see, for example, Case 1 and Case 2 below) could be situations where the purchase of a specific financial instrument cannot be recommended to a client because that instrument is unsuitable for him and the firm influences that client to proceed with the transaction at his/her own initiative (for instance, by emphasising only the positive aspects of the product); or where the firm purposely changes the client's profile (without there being any real change in the client's situation that would justify such a modification of the profile) in order to make suitable a financial instrument that is unsuitable for him/her, so as to be able to recommend it.

CASE 1: Client A has an ongoing relationship with Firm X for the provision of investment services, including investment advice. Firm X has a contractual relationship with a third party (e.g. Company Z) for selling products issued by Company Z itself.

Client A would like to make an investment and, in the context of his relationship with Firm X, asks for an advice from the firm. The firm, knowing that an investment in products issued by Company Z would be unsuitable for client B, deliberately raises his profile (although no changes in the clients' situation, that would justify such a change, have effectively occurred), so as to be able to recommend them.

CASE 2: Client B has an ongoing relationship with Firm Y for the provision of investment services, including investment advice. Firm Y is also the issuer of product Y and has a specific interest in placing it in order to meet its funding needs.

In the context of the relationship with client B, the firm, being aware that product Y would not be suitable given the client's financial situation, their investment objectives and their knowledge and experience, decides to influence him to buy product Y at his own initiative, for example by emphasising all possible advantages of such an investment. As a consequence, the client executes the transaction under the appropriateness test or execution only, without the protections afforded by the suitability assessment.

On the contrary, there might in practice also be situations (see, for example, Case 3 below) where the firm is confronted with clients who insist in taking a course of action that the firm has assessed as being unsuitable for him/her, therefore acting against the firm's advice (so called 'insistent clients').

CASE 3: Client C has an ongoing relationship with Firm W for the provision of investment services, including investment advice.

In the context of this relationship, client C contacts the firm at its own initiative, asking its advice about what investment he should choose between product A and product B. The firm, that does not have any specific interest in selling either of the mentioned products, undertakes a suitability test and assesses that only the investment in product B is suitable for client C, but despite the firm's recommendation, the client insists in buying product A. Client C will therefore execute the transaction under the appropriateness test (if the product is complex) or at his own risk, in execution-only (if the product is not complex and the transaction is regarded as being at the client's initiative), despite the firm's advice not to buy product A.

In situations where the client insists in proceeding with the transaction at his/her own initiative, against the firm's advice, that client should be clearly informed of the fact that the course of action that he/she wishes to undertake is not suitable for him/her, including a clear explanation of the potential risks he would incur into by doing so.

In order to ensure compliance with MiFID II framework, firms should in any case put in place arrangements enabling them to retrace and keep records of the steps of their interaction with clients, so as to be able to demonstrate whether the transaction executed was indeed originated by the client's initiative[10] or by the firm's initiative. Firms should periodically review these records to monitor that the interaction with their clients was correctly conducted and to identify potential practices and behaviours non-compliant with MiFID II rules. For example, recurring switches from investment advice to execution services at the client's initiative, or changes of client's profiles near the closing date of any transaction, not supported by a real modification of the client's situation that would justify such a change.

There are particular instances, such as firms selling their own financial instruments (or selling financial instruments issued by entities of the same group) or actively marketing products from within the firm's range, where there is a heightened risk that a firm might indeed act in accordance with its own interests, rather than in the best interests of its clients. In such circumstances, where there is a heightened risk of non-compliance with MiFID II rules due to the existence of significant conflicts of interests, firms may also decide, of their own accord and where compatible with national laws, to put in place processes and procedures that do not allow the client to proceed with a transaction under execution services in relation to a specific financial instrument if that instrument is unsuitable for him. Similar arrangements could also be adopted in relation to insistent clients.

Firms remain subject to all relevant MIFID II requirements and, in particular, to the overarching obligation of acting in accordance with the best interests of their clients.

Question 7 [Last update: 10 October 2016]

When a firm provides the investment service of advice or portfolio management to a client who is unwilling to fully disclose information on his/her financial situation, can the firm assess the suitability of the envisaged transaction? If yes, under which conditions?

Answer 7

When providing investment advice or portfolio management services, the firm must collect from the client all 'necessary information' required by Article 25(2) of MiFID II and Article 54(2) of the MiFID II Delegated Regulation. Moreover, paragraph 8 of the aforementioned Article 54 clarifies that in cases where the investment firm does not obtain such information, it shall not recommend investment services or financial instruments to that client or potential client.

The required information has to be considered in light of all the features of the investment advice or portfolio management services. In any case, the firm has to be able to assess the client's ability to understand and financially bear the relevant risks associated with the

[10] Recital 85 of MiFID II states that "*a service should be considered to be provided at the initiative of a client unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients.*"

investment. Nevertheless, the depth and detail of the required information are subject to the proportionality principle, for example they can vary depending on the complexity, risks and structure of the financial instrument and on the nature and extent of the service provided. In particular, it should be reminded that for more complex and risky products, as well as for the illiquid ones, the firm should consider whether more in-depth information may need to be collected, so as to be able to carry out the aforementioned assessment[11].

Accordingly, it is the responsibility of the firm to decide whether, in limited situations, the suitability of certain products could be assessed without getting full disclosure about a client's financial situation. That may be the case, for example, where a client discloses only a part of his/her assets but also provides adequate information to evidence all his/her existing liabilities (such as bank loans, outstanding debts, etc.), and that no further liabilities exist. In these situations, the information provided by the client about his/her liabilities needs to be comprehensive. The firm must be capable, on the basis of the information disclosed by the client, to assess whether the client's assets are sufficient for him/her to bear any related investment risks, including the possible losses that can occur when investing in the respective instrument.

In accordance with Article 54(7) of the MiFID II Delegated Regulation, firms are responsible for ensuring that the information collected from clients is reliable and need to take reasonable steps to this effect. They could, for example, check such information against other relevant sources that may be available to the firm itself[12].This could be the case, for example, for a bank providing not only investment services, but also traditional banking services, that may have knowledge of an existing bank loan or other outstanding debts and liabilities. In any case, if the firm becomes aware that the information provided by the client about his/her existing liabilities is not accurate, it should refrain from giving investment advice or offering portfolio management services.

The fact that the suitability of the product/service was assessed without getting full disclosure about the client's financial situation should also be set out clearly in the suitability report provided to the client.

Question 8 [Last update: 16 December 2016]

Where a firm is subject to several record keeping and documentation obligations in connection with the provision of investment advice, is the firm required to draft distinct documents or would one document containing the requirements of all of these different documents be sufficient?

[11] This is in line with ESMA's 'Guidelines on certain aspects of MiFID suitability requirements' published in 2012 [Ref: ESMA/2012/387].

[12] This is in line with ESMA's 'Guidelines on certain aspects of MiFID suitability requirements' published in 2012 [Ref: ESMA/2012/387].

Answer 8

MiFID II requires firms to comply with the following record keeping and recording obligations:

- The requirement, included in Article 16(6) of MIFID II, to record all services, activities and transactions;

- The requirement, included in Article 25(6) of MiFID II, to provide clients with reports on all services provided and in particular to provide a statement on suitability in case of the provision of investment advice, regardless of whether or not the investment advice is followed by a transaction (see Q&A 1).

Furthermore, in accordance with Article 16(7) of MiFID II, face-to-face conversations that relate to, at least, transactions concluded when dealing on own account or in the provision of client order services that relate to the transmission and execution of client orders, including such conversations and communications that are intended to result in transactions, shall also be recorded. These conversations may include conversations in the context of the provision of investment advice, if that advice results or may result in the provision of the services of reception, transmission and execution of client orders. The content of these face-to-face conversations may be recorded by using written minutes or notes, according to Article 16(7) of MiFID II and Article 76(9) of the MiFID II Delegated Regulation.

While the requirements[13] have to be complied with individually, it is reasonable to allow firms to draft one single document as long as:

- the content of such document is consistent with all corresponding requirements;

- a record of the document is kept by the firm for the prescribed period;

- when required by one of the corresponding MIFID II provisions the document is provided or made available to the client in the prescribed conditions.

[13] Articles 16(6), 25(6) of MiFID II, and16(7) of MiFID II in relation to records of face-to-face conversations.

3 Recording of telephone conversations and electronic communications’ [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Which internal telephone conversations or electronic communications regarding the handling of orders and transactions need to be recorded?

Answer 1

Internal telephone conversations and electronic communications that *“are intended to result in transactions”* or “*relate to”* the reception and transmission of orders, execution of orders on behalf of clients and dealing on own account are subject to the MiFID II Article 16(7) recording requirement.

Recital 57 of MiFID II sets out that: *“such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account”*.

As an example, such records should include conversations or communications by which the sales desk will request a quote from the trading desk on a financial instrument before concluding a transaction with a client. It may also include conversations or communications that are within scope and made to or from the sales and research desks.

Therefore, ESMA expects firms to record all internal telephone calls or electronic communications regarding the handling of orders and transactions. However, ESMA would not ordinarily expect persons carrying on back-office functions to be captured by the requirements.

To clarify, the records of any internal face-to-face conversations that relate to the reception and transmission of orders, execution of orders on behalf of clients and dealing on own account will be caught by the general record-keeping requirements under Article 16(6) of MiFID II.

Question 2 [Last update: 10 October 2016]

Can firms charge their clients to access recordings?

Answer 2

MiFID II enables clients to request access to records of telephone conversations and electronic communications kept in accordance with Article 16(7) of MiFID II. ESMA considers that a decision on whether to charge a client for access to such records is within the discretion of the firm. There is no prohibition in MiFID II on this point. However, firms are expected to pay due regard to the national laws in their respective jurisdiction on whether it is permissible to charge clients to access recordings[14].

ESMA therefore expects that, if a firm decides to charge its client, any charge must be reasonable in order not to deter clients from making such requests.

Question 3 [Last update: 10 October 2016]

The MiFID II Delegated Regulation requires firms to periodically monitor the records of transactions and orders subject to these requirements including relevant conversations and that the monitoring shall be risk based and proportionate. How should these requirements be applied?

Answer 3

The monitoring of records of relevant telephone conversations and electronic communications is necessary to assist the firm in ensuring that it is meeting the recording requirements and also adhering to its wider regulatory obligations under MiFID II. For example, it will assist the firm in meeting its wider regulatory obligations which include but are not limited to having policies and procedures in place in respect of its client order handling, best execution, own account dealing obligations and the deterrence and detection of market abuse.

In determining the firm's approach to monitoring the recording requirements, which includes the frequency and scope of such monitoring, ESMA expects firms to put in place arrangements which are appropriate to the nature, size and complexity of its business.

The approach should consider the likelihood of misconduct in relation to market manipulation or non-compliance with the obligation to act in the best interest of clients in connection with the reception, transmission and execution of client orders and when dealing on own account. In any case, the following criteria should be taken into account when determining the appropriate frequency and scope of monitoring the records: (i) volume and frequency of dealing on own account, (ii) volume, frequency and characteristics of client orders, (iii) characteristics of clients, (iv) financial instruments and services offered and (v) current market conditions with regard to specific securities. This list is non-exhaustive.

Furthermore, the results of any monitoring activities (including the risk assessment carried out by the compliance function) and of any relevant internal or external audit findings on the recording of conversations and electronic communications should be taken into account to determine the frequency and scope of the monitoring.

[14] Firms should bear in mind that the Article 12 of the Data Protection Directive 95/46/EC states that every data subject should be guaranteed a right of access "*without excessive delays or expense*".

The monitoring should be conducted regularly and when necessary on an ad-hoc basis. Due regard should also be given to any emerging risks.

The monitoring should at least aim at:

- assessing compliance with recording procedures in place,
- assessing the adequacy of such procedures,
- ensuring that the records are readily accessible; and
- ensuring that the records accurately reconstruct the audit trail of a transaction.

Question 4 [Last update: 10 October 2016]

Under Article 16(7) of MiFID II, competent authorities may request that a firm keeps the records for up to a period of seven years, rather than five years. In such cases, what are the expectations by competent authorities on the retention of records?

Answer 4

Firms are required to keep records produced under Article 16(7) of MiFID II for five years, with the extension to seven years, if requested by the competent authority. For example, extensions may occur when a competent authority undertakes complicated regulatory investigations in the course of exercising its supervisory powers. This can also occur, for instance, when the competent authority is conducting an investigation on an issue dating several years prior to the start of the inquiry. If a competent authority has not made a request to a firm to put aside recordings within five years from the beginning of the retention period, the firm does not have to keep those recordings for longer than five years from when the record was created. However, if within five years from when the record was created, a competent authority asks firms to retain the recordings, recordings should stop being deleted and should be retained until the competent authority needs them or the competent authority indicates that the recordings are no longer of interest.

Where a firm has been asked to preserve information which may be of interest and the competent authority subsequently concludes that they have no further interest in that information, the competent authority should inform the firms as quickly as possible. If a firm is unclear on whether it should continue to retain material, it should contact the competent authority for confirmation of the position. Nevertheless, no request from the competent authority can extend the retention period for firms beyond seven years.

Question 5 [Last update: 10 October 2016]

What types of electronic communications are within the scope of the new requirements?

Answer 5

Article 16(7) of MiFID II requires the recording of telephone conversations or electronic communications. Any electronic communications involving transactions when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders will fall within the rules. The term "electronic communication" covers many categories of communications and includes amongst others video conferencing, fax, email, Bloomberg mail, SMS, business to business devices, chat, instant messaging and mobile device applications.

ESMA will not produce an exhaustive list of electronic communications because of the continuing innovation and advancement in technology which would mean the list frequently becomes out of date.

Question 6 [Last update: 10 October 2016]

Is the compliance function sufficient to fulfil the requirement to periodically monitor the records of transactions and orders? Or should it be a separate, specifically organised function?

Answer 6

MIFID II, and its implementing measures, do not require the establishment of another control function on top of those already provided for by MIFID I: compliance function, risk management function and, where appropriate, internal audit function. Firms are reminded of their requirements under Article 9(3) of MiFID II and Article 76(2) of the MiFID II Delegated Regulation.

Therefore, while not being necessarily another specific control function, the periodic monitoring of the records of relevant telephone conversations and electronic communications is an essential piece of the overall compliance and monitoring system a firm has to implement through governance arrangements.

Question 7 [Last update: 10 October 2016]

Is the recording of telephone conversations and electronic communications a critical or important operational function for the purposes of the outsourcing rules?

Answer 7

Firms may use third-party recording services to meet the new requirement to record telephone conversations and electronic communication. However, ESMA considers that, for the purposes of the outsourcing rules, taping will be considered a critical or important operational function.

Question 8 **[Last update: 10 October 2016]**

Do relevant telephone conversations and electronic communications need to be recorded by the firm from start to end?

Answer 8

In ESMA's view, the scope of the requirements require firms to record the entirety of telephone conversations and electronic communications. This is because it is impossible to appreciate upfront whether the conversation will lead to the conclusion of a transaction.

Therefore, ESMA expects firms to record all relevant telephone conversations or electronic communications from start to end.

Question 9 **[Last update: 10 October 2016]**

MiFID II enables clients to request access to records of their telephone conversations and electronic communications with the firm. Does this right also cover internal communications within the firm?

Answer 9

MiFID II states that records kept in accordance with Article 16(7) of MiFID II shall be provided to the client involved upon request. This extends to internal conversations and communications between employees and contractors of the firm which relate to the provision of the client's order.

Question 10 **[Last update: 10 October 2016]**

Are employees or contractors permitted to use mobile devices to enable them to undertake activities relating to transactions concluded when dealing on own account and the provision of client order services?

Answer 10

Firms may permit relevant persons to use mobile devices to undertake activities relating to transactions concluded when dealing on own account and the provision of client order services. This includes devices owned by the firm which are expressly authorised for use and devices which are personally owned and used to make relevant conversations. Whatever the circumstance, a firm shall take all reasonable steps to prevent a relevant person from making, sending or receiving relevant telephone conversations and electronic communications on devices which the firm is unable to record or copy.

Firms are required to establish, implement and maintain an effective recording of telephone conversations and electronic communications policy. This policy should therefore cover the requirements relating to mobile devices.

For example, the policy should cover, amongst other factors, the fact that data must be retained for a period of at least 5 years, relevant persons should be prevented from being able to delete records. It should cover what happens to the data/device if a relevant person leaves a firm and what happens in the event that the device is lost or stolen. Additionally, it should also stipulate the frequency of transferring data from the mobile device (whether privately owned or expressly authorised for use by the firm) to the firm's own data retention database.

Question 11 [Last update: 10 October 2016]

What telephone conversations and electronic communications should be recorded in accordance with Article 16(7) MIFID II?

Answer 11

In ESMA's view, the following stages of conversations and electronic communications[15] that relate to the provision of client order services or dealing on own account will be caught by the rules:

- Conversations or communications with a client, or a person acting on behalf of such a client, which relate to an agreement by the firm to carry out one of the covered activities, whether as principal or agent.

- Conversations or communications with any other person, which relate to transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. This should include telephone conversations or electronic communications such as: transmitting an order to a broker or placing an order with an entity for execution, conversations or communications relating to the handling of an order (including solicitations and acceptance of transactions).

Also included, are any other conversations or communications which are carried out by the firm with a view to reach an agreement to carry out one of the covered activities, whether as principal or agent, even if those conversations or communications do not lead to the conclusion of such an agreement[16]. This should include conversations and communications regarding prices, solicitations, bids, offers, indications of interest and requests for quotes.

[15] For example, transactions concluded through online websites, online platforms and smart phone applications.
[16] Second sub-paragraph of Article 16(7) MiFID II.

Firms should have in place policies and procedures to ensure that no relevant telephone conversations or electronic communications are done through communication systems which are not recorded.

Firms will have to decide which devices these relevant conversations or communications will take place on and ensure the effectiveness of their arrangements. Firms will have to ensure that relevant persons are trained on the procedures governing the requirements in Article 16(7) MiFID II[17].

[17] Article 76(5) of MiFID II Delegated Regulation.

4 Record keeping [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

How should firms prepare copies of records that have been encrypted and which have been requested by clients, competent authorities or other competent third parties?

Answer 1

For records that are captured by the requirements under Article 16(6) and 16(7) of MiFID II, ESMA expects firms to have the organisational and administrative capabilities to convert any encrypted data into an unencrypted format.

ESMA expects firms to deliver or make available copies of these records in an unencrypted and easily analysable format, or provide the means that such data can be unencrypted when requested by the client, competent authority or other competent third party.

5 Investment advice on an independent basis [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Could a firm still hold itself out as being independent where it assesses and compares a sufficient range of financial instruments available (which are not limited to financial instruments issued or provided by the firm itself or by entities having close links) but that the outcome of such an assessment in a considerable number of cases is that the firm recommends financial instruments to its clients which are issued or provided by the firm itself or by entities having close links?

Answer 1

When a firm holding itself out as being independent frequently assesses financial instruments which are issued or provided by the firm itself or by entities having close links as best suited for its clients, ESMA considers this could potentially conflict its status as 'independent'.

Independent advisers are reminded of their obligations stemming from MiFID II (and in particular Article 24(4) and 24(7)) and implementing measures (in particular Articles 52 and 53 of the MiFID II Delegated Regulation). A firm is also expected to manage conflicts of interest at all times. In doing so, the firm should establish, implement, maintain and update regularly adequate internal systems and controls in order to ensure that it is not bound by any form of agreement with a product provider that may limit the firm's ability to provide a personal recommendation which is unbiased and based on an assessment of a sufficient range of financial instruments available on the market. Also a regular review of the service and financial instruments it offers should be performed by the firm. Consequently, ESMA expects that these internal controls and systems should provide for a permanent internal awareness of its independency status.

In practice this means that the outcome of the unbiased and unrestricted analysis of the financial instruments available on the market could occasionally result in the firm recommending its own products. However, if the outcome is that the firm routinely recommends its own products or if there appears to be a systematic bias to advise clients to invest in its own products, the firm would most likely have problems in demonstrating the provision of advice on an independent basis. In such a case ESMA expects the firm to do thorough internal assessments determining if and to what extent clients' interests are or could be affected. Such an internal assessment should at least consider information on how the firm assessed and compared financial instruments which are issued or provided by the firm itself or by entities having close links versus a sufficient range of financial instruments available on the market. Also it should make clear the factors the assessment has been based upon and which factors determined the outcome. The firm should be able to provide this analysis to its clients and on request to the supervisory authority.

6 Underwriting and placing [Last update: 16 December 2016]

Question 1 [Last update: 10 October 2016]

Article 38(1)(a) of the MiFID II Delegated Regulation states that "investment firms which provide advice on corporate finance strategy, as set out in Section B (3) of Annex I, and provide the service of underwriting or placing of financial instruments, shall, before accepting a mandate to manage the offering, have arrangements in place to inform the issuer client of the various financing alternatives available with the firm". What are "the various financing alternatives" to be considered?

Answer 1

The various financing alternatives may be limited to those appropriate to the issuer client's needs. However, they should not be limited to financing alternatives that constitute investment services; for example, loans or extension of credit facilities shall be included if appropriate and offered by the firm. The firm should inform the issuer client which financing alternatives have not been considered, including financing alternatives not offered by the firm, with a short explanation of why they were discounted.

Question 2 [Last update: 16 December 2016]

Article 38(1)(d) of the MiFID II Delegated Regulation states that "investment firms which provide advice on corporate finance strategy, as set out in Section B(3) of Annex I, and provide the service of underwriting or placing of financial instruments, shall, before accepting a mandate to manage the offering, have arrangements in place to inform the issuer client of the details of the targeted investors, to whom the firm intends to offer the financial instruments". Are investment firms required to provide details of each individual investor client or per type of investor client?

Answer 2

Before accepting a mandate to manage the offering, information on targeted investors should be provided at least by per type of client, for example long-term or short-term investors, size, and nature of investor (e.g. pension funds, sovereign wealth funds, hedge funds and private clients), and country. This should reflect the specific needs or preferences of the issuer client, acting as a supplement to the investment firms' overarching allocation policy. This is consistent with Article 40(5), which states that, during the placing process (once a mandate has been awarded), investment firms shall "obtain the issuer client's agreement to its proposed allocation per type of client for the transaction in accordance with the allocation policy".

Furthermore, when carrying out the activities of underwriting and placing, investment firms should be aware of their product governance obligations, in particular in relation to the identification of the target market.

Question 3 [Last update: 16 December 2016]

What records should be kept by firms when providing underwriting or placing services and how should firms justify their final allocations to each investment client?

Answer 3

In order to be able to demonstrate to NCAs how they meet their obligations to the issuer client when providing underwriting and placing services, as well as their obligation to manage conflicts of interest between different clients or groups of clients, firms should have a process to record allocation decisions at material stages in the allocation process.

Records of allocations decisions should include:

a. The firm's overarching allocation policy under Article 40(4) in force at the time of the commencement of the service;

b. The firm's initial discussion with the issuer client and the agreed proposed allocation per type of investment client, as required by Article 40(5);

c. The content and timing of allocation requests received from each investment client with an indication of their type;

d. Where relevant, any further discussion and instructions or preferences provided by the issuer client, other members of the syndicate, or the firm itself, on the allocation process, including any emerging in light of allocation requests received from investment clients;

e. The final allocations registered in each individual investment client's account.

Firms must provide a justification for the final allocation made to each investment client. For this purpose, a justification should explicitly provide detailed reasoning behind the final allocation unless firms can evidence that such detail has been provided through records maintained at stages (a-e) in the allocation process. Particular care should be given to justifications to any investment clients that appear in either of the following two rankings of the final allocation:

(i) investors that receive a final allocation (recorded in (e) above) in the top 20% of the total allocation ranked by investor in descending order of size of allocation to each investor; or

(ii) investors that receive a final allocation in the top 20% of the total allocation ranked by investor in descending order of the percentage allocation granted to each investor divided by the percentage bid by each investor (i.e. the relative extent to which each investor has their order (recorded in (c) above) reduced in the final allocation (recorded in (e) above).

Question 4

Article 38(1) of the MiFID II Delegated Regulation applies to "investment firms which provide advice on corporate finance strategy as set out in Section B(3) of Annex I of MIFID II and provide the service of underwriting or placing of financial instruments". Does this Article apply to investment firms acting as a manager or a member of the syndicate for a specific offering?

Answer 4

The activities of investment firms acting as a manager or member of the syndicate for a specific offering do not generally imply the provision of advice on corporate finance strategy. When no advice on corporate finance strategy is provided to the issuer client, provisions of Article 38(1) of the MiFID II Delegated Regulation are not to be applied. If, however, advice on corporate finance strategy is provided to the issuer client alongside the service of underwriting and placing, provisions in Article 38(1) will apply. In all circumstances, all other relevant requirements in the MiFID II Delegated Regulation related to underwriting and placing activity remain applicable.

7 Inducements (research) [Last update: 16 December 2016]

Question 1 [Last update: 10 October 2016]

When a firm is using a research payment account under Article 13 of the MiFID II Delegate Directive, can the research budget required under Article 13(1)(b)(ii) and 13(2)(a) be set for more than one client's portfolio when determining the specific research charge to a client and establishing the need for third party research?

Answer 1

While a research payment account (RPA) can only be funded by a specific research charge to the client, which must be based on a research budget set by the firm, ESMA considers that a budget can be set for a group of client portfolios or accounts where the firm has established a similar need for third party research in respect of the investment services rendered to its clients.

This would allow a firm providing investment services to set a research budget at a desk or investment strategy level, for example, if client portfolios have sufficiently similar mandates and investment objectives such that investment decisions relating to those portfolios are informed by the same research inputs. A firm should be able to clearly evidence and demonstrate its approach to setting and managing a budget for a given group of client accounts and that it is consistent with using the budget in the best interests of its clients, as required by Article 13(6) of the MiFID II Delegated Directive. A firm should also describe its approach in a written research policy provided to its clients under Article 13(8) of the MiFID II Delegated Directive.

A firm is still required to identify a specific research charge for individual clients to fund the RPA, even where a budget is set for several portfolios. A firm will therefore need to have a transparent method for making a fair allocation of costs in such cases. This may involve the firm pro-rating the cost of the research budget across all client accounts benefitting from it based, for example, on the value of each client's portfolio, to establish a specific charge for individual clients.

Firms should not set a budget for a group of client portfolios or accounts that do not share sufficiently similar investment objectives and research needs. For example, if portfolios have material differences in the types of financial instruments and / or geographic regions or market sectors they can invest or are invested in, such that their research needs and the potential costs of acquiring those inputs are different, they should not be subject to the same research budget. This would not allow the firm to ensure a budget is used in the best interests of clients and may result in an unfair allocation of the costs, or benefits derived from research purchased, between different sets of clients. A firm may also choose to set a firm-level research budget to help it control overall costs, but this does not replace the need to set budgets for discrete groups of client portfolios and accounts as described above.

Question 2 **[Last update: 16 December 2016]**

What is the legal status of money held in a research payment account (RPA) established under Article 13(1)(b) of the MiFID II Delegated Directive, prior to it being used to pay providers for research?

Answer 2

Under Article 13 of the MiFID II Delegated Directive, where an investment firm chooses to use an RPA, this must be funded by a research charge to the client.

The nature of this deduction as a charge means that once it is deducted from a client, the funds belong to the firm. However, this research fund should be managed in an RPA controlled by the investment firm and it should be used specifically for purchasing external research to benefit the client. ESMA is of the opinion that it is important that the investment firm makes its best efforts to align as much as possible the timing of the charges paid by the client to the firm, and the expenditure on research paid from the RPA by the firm to the research provider.

The obligation on the investment firm to have a process by which it can rebate surplus funds if it underspends the original research budget for a set of portfolios under Article 13(5) of the MiFID II Delegated Directive[18] does not alter the status of RPA money. Only when a rebate has been made into a client's account would it be considered as client assets.

When administration of the RPA is outsourced, the investment firm should maintain legal control over RPA funds until such time as it decides to make a payment to a research provider. Each payment and its amount should be decided with reference to the quality criteria established by the firm itself in its research policy and its assessment of the need for research in the best interest of the client.

The investment firm must be satisfied that through the outsourced agreement it continues to retain full discretion and control over the use of the account.

The money should be ring-fenced and clearly separated from other funds of the RPA Administrator, such that they remain legally owed to the investment firm.

The third party provider should have no right of set-off over the money or be entitled to use it as collateral or otherwise for their own benefit.

Question 3 **[Last update: 16 December 2016]**

How should an investment firm deal with unrequested research that is provided free of charge?

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[18] Or offset it against the research budget and charge calculated for the following period

Answer 3

The provision or reception of research by an investment firm is subject to the rules on inducements in Article 24, paragraphs 7, 8 and 9, of MiFID II, depending on the firm's investment activities.

Firms need to have in place policies and systems to assess the nature of any service, benefit or material paid or provided by any third party to determine whether they can provide or accept it. It is not acceptable for firms to receive research for free where no assessment has been made under the above inducements rules or there is no payment arrangement in place that complies with Article 13 of the MiFID II Delegated Directive.

A firm providing independent investment advice or portfolio management services can only receive research in relation to those activities by complying with Article 13 of the MiFID II Delegated Directive[19]. In this context, firms should not accept research for 'free'.

In relation to services or activities other than those covered under Articles 24(7) and 24(8), a firm providing or receiving research services must assess whether the provision or receipt of the research service meets the quality enhancement test (and the other conditions in Article 24(9)) or decide whether it intends to pay for the research directly or through a separate RPA under Article 13 Delegated Directive.

Where a firm does not want to accept research material, they should take reasonable steps to cease receiving it or avoid benefitting from its content, for example by automatically blocking or filtering certain senders/materials where practicable, and / or requesting a provider to stop providing research, and / or using the compliance function of the firm to monitor, assess and determine whether the material can be accepted before it reaches those parts of the firm that would make use of it. As proportionate to the nature, scale and complexity of its business, a firm should also provide adequate training and / or information to staff to ensure they understand the inducements obligations and the firm's specific approach to receiving research, for example whether or not they have budgeted research expenses or have agreements in place for the provision of research with particular providers to meet Article 13 of the MiFID II Delegated Directive. A firm could also consider having a process whereby staff can report to compliance or senior management any cases of unsolicited research being provided to them from a third party where no payment arrangement or agreement is in place.

Where the provider of research is a firm which also provides execution services under MiFID, and is subject to Article 13(9) of the MiFID II Delegated Directive, the provision of unsolicited (or 'free') research would not meet the obligation on them to price services separately, and ensure its supply does not potentially influence the execution services they supply. On that basis, firms should have systems and controls in place to enable them to cease providing unsolicited research.

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[19] For the purposes of this question, it is assumed a priori that an item or service is research, rather than material that could constitute a minor non-monetary benefit that is acceptable under Article 12(3) of the Delegate Directive (see question 6 of this section below).

Question 4 **[Last update: 16 December 2016]**

Can investment firms accept research from third country providers that are not subject to the MiFID II requirements?

Answer 4

EU/EEA firms subject to MiFID II inducements rules must comply with these requirements (Article 24, paragraphs (7), (8) and (9), and the relevant level two provisions) irrespective of the status or geographical location of the research provider. Alternatively, they could receive research using the paying arrangements set out in Article 13 of the MiFID II Delegated Directive.

Firms should therefore treat research from a third country provider in the same way as any other third party benefits (see Q&A 3 above).

Question 5 **[Last update: 16 December 2016]**

What approach should a firm take to research provided from another group entity?

Answer 5

The MiFID inducements rules apply in the same manner irrespective of the relationship between the provider of fees, commissions or monetary or non-monetary benefits and the firm receiving them, (i.e. irrespective of being part of the same group or not).

On this basis, firms subject to MiFID inducements rules need to either assess whether accepting the inducement (research) is compliant with Article 24(7), (8), (9) and the relevant level two provisions or decide to use the arrangements in Article 13 of the MiFID II Delegated Directive. In the latter case, firms should pay particular attention to any potential conflicts of interests as well as their obligations to assess the quality of research and keep appropriate controls and oversight over the amounts paid with reference to the quality criteria mentioned beforehand. Alternatively, the firm could refuse to accept research from other intra-group entities.

Where firms do seek to receive third party research from or provide it to other group entities using an RPA model under Article 13 of the MiFID II Delegated Directive, the requirement on the EU firm to ensure a research budget is used and managed in the best interests of their clients and that the costs of research are allocated fairly between client portfolios under Article 13(6) and 13(8) of the MIFID II Delegated Directive will be particularly important. The commercial preference of a firm to operate as part of a global business model does not override their obligations under Article 13 if using an RPA. The firm will need to ensure their systems, controls and oversight of research spending and cost allocation to clients are sufficient to meet all the requirements linked to an RPA, notwithstanding that this may require some changes to their business model.

Alternatively, there remains the option for the firm to pay for research with direct payments from their own resources if the RPA and research charge mechanism is deemed too complex.

Question 6 [Last update: 16 December 2016]

In what circumstances should material received by a firm providing independent investment advice or portfolio management services be considered a minor non-monetary benefit under Article 12(3) of the MiFID II Delegated Directive rather than research?

Answer 6

In accordance with Q&A 3 (see above) firms should have in place policies and systems to assess the nature and scale of any service, benefit or material provided by any third party to determine whether it can be considered as a minor non-monetary benefit or as research subject to Article 13 requirements.

Whereas an overall definition of minor non-monetary benefits is provided for in Article 24 (8) of MIFID II, and specific items are provided for in Article 12(3) of the MiFID II Delegated Directive, Recital 29 of the MiFID II Delegated Directive provides some further clarity in relation to certain types of information or material. It states that in particular "non-substantive material or services consisting of short term market commentary on the latest economic statistics or company results" that firms providing independent investment advice or portfolio management may treat as minor non-monetary benefits.

The assessment of whether material is substantive or not (and therefore can be viewed as a minor non-monetary benefit) should only be linked to its content and not to the qualification given/alleged by the provider nor its provenance within the third party provider. Article 12(3) of the MiFID II Delegated Directive makes clear that for any third party benefits to be an acceptable minor non-monetary benefits, a firm should assess and ensure they are "reasonable and proportionate and of such a scale that they are that they are unlikely to influence the firm's behaviour in any way that is detrimental to the interest of the relevant client."

For example, a detailed research report or conversation with a research analyst, which in content meets the nature of research described in Recital 28, cannot be considered as a minor non-monetary benefit due to it being labelled as such by a provider or because such material is provided through a dealing desk rather than a research department. By contrast, short market updates with limited commentary or opinion may be capable of being considered as information that is a minor non-monetary benefit consistent with Recital 29 and Article 12(3)(a) of the MiFID II Delegated Directive. The restriction on inducements, including research, should also not prevent communications between a firm's trading desk and a trader in another firm's dealing desk in the context of seeking market information to immediately execute an order, for example on available liquidity or recently traded prices, which should be considered as part of the execution service. Material repeating or summarising public news stories or public statements from corporate issuers (e.g. public quarterly results reports or other market announcements) could also be considered as information that constitutes a minor non-monetary benefit.

Recital 29 also refers to Article 12(3)(b) of the MiFID II Delegated Directive. This provides that a minor non-monetary benefit can include “written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company… provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public”. This exemption can allow investment firms to receive ‘pre-deal’ material directly relating to a new capital raising event by an issuer, which is produced by a third party such as another investment firm who is placing and / or underwriting the issue (often referred to as ‘connected research’), provided that the nature of the material is made clear and it is available at the same time to any prospective investor.

Article 12(3)(b) also allow investment firms to accept material from a third party where they are “contractually engaged and paid by the issuer to produce such material on an ongoing basis”, again subject to the relationship being clearly disclosed within it and the material being made available at the same time to any investment firms wishing to receive it or to the general public. This permits so-called ‘issuer sponsored’ third party coverage to be distributed and received by an investment firm as a minor non-monetary benefit, provided that it is offered generally either to any investment firm or is made public. In both cases under Article 12(3)(b) of the MiFID II Delegated Directive it is clear that there should be no expectation or actual payment from a recipient investment firm for such material or restriction in access that could in any way infer the provision of this material could act as an inducement and not constitute a ‘minor’ benefit.

Recital 30 of the MiFID II Delegated Directive finally clarifies that “any non-monetary benefit that involves a third party allocating valuable resources to the investment firm shall not be considered as minor and shall be judged to impair compliance with the investment firm's duty to act in their client’s best interest.”

8 Post-sale reporting [Last update: 16 December 2016]

Question 1 [Last update: 16 December 2016]

How does a firm fulfil the obligation to report on the overall value of a client's portfolio depreciating by a 10% threshold on a particular business day if a firm's automated systems do not provide valuations throughout the day for all the portfolios it manages? In line with this question: could a firm use a single daily valuation point as the basis for the evaluation?

Answer 1

Article 25(6) of MiFID II requires firms to provide clients with adequate reports on the investment service provided. These reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client. In addition, Article 62(1) of the MiFID II Delegated Regulation requires firms to meet additional reporting obligations so clients are made aware when the overall value of their portfolio, as evaluated at the beginning of each reporting period, depreciates by 10% and thereafter at multiples of 10%. So, a firm is obliged to value the overall portfolio at the beginning of the reporting period and evaluate the overall portfolio at least once each day, but is not obliged to have systems in place that calculate valuations on an on-going basis throughout each day.

One way a firm could provide the required reports would be to set a fixed portfolio valuation point for each day, for example at 06.00 hours after any overnight reconciliation is complete, and identify whether the depreciation threshold is exceeded by comparing this value with the valuation of the portfolio at the beginning of the reporting period. Then, if the portfolio value is shown to have depreciated by 10% or more, the firm would inform the client by the end of that business day. Assuming its business day ends at 17.00 hours, this approach would give firms 11 hours in which to report to clients during working hours. Adopting one fixed valuation point for each day would also avoid multiple reports being triggered during volatile market periods.

Question 2 [Last update: 16 December 2016]

When fulfilling the obligation to report on a portfolio depreciating by the 10% threshold, does the firm need to report if a portfolio value drops by more than 10% as a result of the client making cash withdrawals?

Answer 2

The obligation is to report if the overall value of a portfolio, as evaluated at the beginning of each reporting period (usually every three months), depreciates by 10% and thereafter at multiples of 10%. When cash withdrawals are made from a portfolio, the value of the managed financial instrument or funds is reduced by the amount of the client money transferred; but the overall value of the portfolio, as evaluated at the beginning of the previous reporting period, includes the value of the cash withdrawn. So, if clients withdraw cash from a portfolio, until a periodic statement is provided that discounts the cash withdrawn, when calculating the overall value of a portfolio, to see whether the 10% thresholds are exceeded, a firm will need to take this cash into account by adding its value to the value of remaining financial instruments or funds in the portfolio.

Question 3 [Last update: 16 December 2016]

How does a firm fulfil the obligation to report if the values of a client's leveraged financial instruments or contingent liability transactions depreciate by a 10% threshold on a particular business day, if a firm's automated systems do not provide valuations throughout the day for all the instruments held?

Answer 3

In line with the response to Q&A 1 (on portfolio reporting), in order to identify whether there has been a depreciation by 10% or more, a firm could set a fixed daily valuation point for its leveraged financial instruments and inform clients in the same time frame set out in Q&A 1.

Article 62(2) of the MiFID II Delegated Regulation requires firms to report to clients that hold positions in leveraged financial instruments or contingent liability transactions, where the initial value (original cost) of each instrument depreciates by 10% and thereafter at multiples of 10%. It applies on an instrument-by-instrument basis, unless otherwise agreed, and shall take place no later than the end of the day in which the threshold is exceeded. MiFID II Delegated Regulation, Recital 96 states that a 'contingent liability transaction' should involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument. There is no similar explanation of what a 'leveraged financial instrument' is. However, given Recital 96 and the objective of Article 62(2), firms should conclude that if a financial instrument has the potential of magnifying an investor's exposure to an underlying risk then this will result in the instrument being a leveraged financial instrument.

9 Information on costs and charges [Last update: 16 December 2016]

Question 1 [Last update: 16 December 2016]

How can a personalised ex-post disclosure of costs of the fund be made, if the client buys and sells a fund during the business year?

Answer 1

Based on Article 50(9) of the MiFID II Delegated Regulation, an investment firm that has or has had an ongoing relationship with a client, shall provide this client with ex-post information on the total costs and charges. Such information shall be based on costs incurred and shall be provided on a personalised basis.

For calculating the total costs during the year (in which the costs of the fund are taken into account), first of all the holding period of the fund is needed. The firm will have insight in this. Secondly, an investment firm has to have annualised information on ongoing realised costs and charges with regard to the financial instrument. Where this data is not already publicly available, the firm should liaise with the manufacturer (e.g. the fund manager) to obtain information on costs and charges of the financial instrument. The firm should assess itself or inquire with the manufacturer whether the costs incurred in the holding period adequately reflect the costs incurred over the whole year. If this is the case, the firm could choose to use the annual costs of the financial instrument to calculate the costs during a specific holding period. If this is not the case, the firm will, on a best effort basis and possibly with the manufacturer's help, have to make adjustments to ensure that it does reflect the actual costs incurred.

For clarification, ESMA notes that there might also be one-off costs involved in buying and selling the financial instruments. This could include mark-ups. The firm has to account for these, based on the actual costs.

Question 2 [Last update: 16 December 2016]

To what extent does the cumulative effect of the costs on the return need to be graphically displayed?

Answer 2

Based on Article 24(4) MiFID II and Article 50(10) of the MiFID II Delegated Regulation, firms have to provide clients with an illustration to show the cumulative effect of the costs on the return. The format of the illustration is not prescribed. This means that the illustration required can take multiple forms, among others a graph, a table or a narrative. However, it is required that (i) the illustration shows the effect of the overall costs and charges on the return of the investment, (ii) the illustration shows any anticipated spikes or fluctuations in the costs (where applicable), (iii) and that the illustration is accompanied by a description of the illustration.

Question 3 [Last update: 16 December 2016]

The cumulative effect of the costs on the return shall show "anticipated spikes and fluctuations of the costs"; does that also apply to the ex-post disclosure of the cumulative effect of the costs on the return?

Answer 3

Based on Article 24(4) MiFID II and Article 50(10) of the MiFID II Delegated Regulation, firms have to provide clients with an illustration to show the cumulative effect of the costs on the return.

When providing the client ex-post with information on total costs and charges, a firm can for instance decide to show the historical costs, and simultaneously provide the client with a forward looking illustration with regard to expected costs. In this case, the firm can show the historical costs that show a spike, for instance because of entry costs, and future expected costs based on the firm's expectations (including anticipated spikes and fluctuations).

If the ex-post illustration takes into account only historical data, the firm has to account for realised spikes and fluctuations in costs. However, since these data are historical, there are no 'anticipated' spikes.

Question 4 [Last update: 16 December 2016]

How often should a firm provide ex-post information on total costs and charges?

Answer 4

Based on Article 50(9) of the MiFID II Delegated Regulation, firms shall provide information about the total costs and charges on an annual basis. This means that firms should ensure that once a year the client receives an overview of the total costs and charges incurred in the previous year, based on their personal circumstances and actually incurred costs. These costs and charges shall be totalled and expressed both as a cash amount and as a percentage, as is also described in Article 50(2) of the MiFID II Delegated Regulation.

In addition to the abovementioned obligation, there is room for firms to provide this information more frequently, for instance every time the client receives a (quarterly) report about the investments.

Question 5 [Last update: 16 December 2016]

How can a firm provide ex-post information on total costs and charges more regularly (e.g. on a quarterly basis)?

Answer 5:

ESMA notes that based on Article 50(9) of the MiFID II Delegated Regulation, and without prejudice to any other explicit reporting requirements (e.g. Article 60 of the MiFID II Delegated Regulation), there is only a legal obligation to provide ex-post information on costs and charges to clients on an annual basis if there is or has been an ongoing relationship with the client during the year. However, firms can choose to provide this information more regularly, which could improve the clients' insights in the costs and charges of the investment service (based on an ongoing relationship).

If a firm chooses to provide the client with more frequent information, for instance on a quarterly basis, it should ensure the differences between the annual ex-post figures based on actual costs, and the quarterly cost figures are minimized. The firm could for instance do this by applying the same methodology when calculating the annual total costs and charges figures. Further, the firm should – where available – use realised and known ex-post cost figures.

To ensure clients are not confused by such ex-post information on costs and charges in relation to the mandatory annual costs figures, it is important that the firm informs clients on the characteristics of the ex-post information.