

MiFID II

Suitability

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Key Points

- A specific requirement to take the client's ability to bear losses and risk tolerance into account when assessing suitability will be introduced.
- The provisions of the MiFID Implementing Directive will be replaced with new requirements to ensure that firms meet their suitability obligations as intended, including to act in the client's best interest, to gather reliable information, to ensure suitability when recommending a sell/hold action, and to ensure that automated systems do not diminish a firm's responsibility.
- Firms will be required to provide additional information in suitability reports to clients.

Background

Article 19(4) of the MiFID I Directive contains high level obligations requiring firms to obtain necessary information from clients before assessing the suitability of an investment for a client. This applies when a firm makes a personal recommendation or a decision to deal on a discretionary basis. Under MiFID I, further detailed provisions are contained in Articles 35 and 37 of the MiFID Implementing Directive.

The high level obligations in MiFID I will be changed to some extent by the MiFID II Directive. The more detailed requirements of the MiFID Implementing Directive will also be supplemented and amended as by the requirements in Article 54 of the MiFID II Delegated Regulation.¹ Section 3 of the MiFID II Delegated Regulation covers the assessment of suitability and appropriateness more generally, with Articles 54, 55 and 58 dealing with suitability specifically.

Most of these updates are in the nature of "clarifications" rather than new requirements.²

The main changes being introduced by MiFID II are set out below.

Risk tolerance, ability to bear losses and bundled products

The existing wording at Article 19(4) of the MiFID I Directive will be updated by Article 25(2) of the MiFID II Directive to emphasise the need to ensure that suitability is assessed by reference to the client's "risk tolerance" and "ability to bear losses" and to ensure that, where a package of bundled investment services or products is recommended, that the overall bundle is suitable.

Client's best interests

Firms will be required to notify clients that the purpose of the suitability assessment is to enable the firm to act in the client's best interest, and must not create any ambiguity about the fact that responsibility for suitability rests with the firm.³

Recommendations to hold/sell

Whereas currently, the MiFID Implementing Directive imposes suitability requirements when recommending that a client buys an investment under MiFID II, suitability obligations also apply when recommending a client to hold or sell the investment.⁴

Understanding of relevant instruments and alternatives

Firms will be required to have the necessary understanding of instruments selected for clients. Firms will need to assess, taking cost and complexity into account, whether equivalent financial instruments would meet the client's needs. Firms will be required to put policies and procedures in place to ensure they meet these requirements.⁵

Restricted advice

Where a firm advises only on a limited range of instruments, it must not make a recommendation where none of those instruments are suitable.⁶

¹ Commission Delegated Regulation (EU) of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the "**MiFID II Delegated Regulation**").

² In our view, these changes are already broadly in line with what the United Kingdom's FCA will generally expect of UK firms where they assess suitability.

³ Article 54(1), MiFID II Delegated Regulation.

⁴ This mirrors what is already the UK FCA's position on what constitutes investment advice generally.

⁵ Article 54(9), MiFID II Delegated Regulation.

⁶ This mirrors the FCA's current position where firms give limited advice.

Switching

Before recommending a course of action that will involve switching investments, a firm must collect necessary information on the existing investments and undertake a cost/benefit analysis to ensure that the benefits of switching outweigh the costs before recommending the switch.⁷

Ongoing advice

Where a firm provides ongoing advice it must maintain adequate and up-to-date information about the client in order to assess the continuing suitability of such advice.⁸

Information in context of service

A firm's determination of what information is required from the client to make a suitability assessment shall be made in light of all the features of the services to be provided.⁹

Collection of reliable information

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

- ensuring that clients are aware of the need to provide accurate up-to-date information;
- ensuring that tools used to assess suitability are fit for purpose, with any limitations being identified and actively mitigated during suitability processes;
- ensuring that questions asked are likely to be understood by clients; and
- taking steps to ensure the consistency of client information and considering whether responses are obviously inaccurate.¹⁰

Multiple client entities and legal entities

Where a single client relationship comprises multiple entities (such as a married couple), or where the client is a legal entity, the firm must establish and implement a policy to determine who should be subject to the suitability assessment. The policy should also consider how the suitability assessment will be carried out in practice, including who information relating to knowledge and experience, financial

situation and investment objectives should be collected from. The firm should record this policy.¹¹

Client representatives

Where an individual client is represented by another individual (e.g. if the client's spouse is appointed to act on behalf of the client), the financial situation and investment objectives of the client should be considered for the suitability test. However, it is the knowledge and experience of their representative which should be considered.¹²

Automated systems

MiFID II clarifies that where a firm relies on an automated or semi-automated system for the provision of relevant services, its responsibility for suitability is in no way diminished. This would apply, for example, where a firm used an automated system to provide web-based advice or portfolio with agreement services.¹³

Suitability reports

Suitability reports will need to include:

- an outline of the advice given;
- an explanation of why the recommendation is suitable, including how it meets the client's objectives and personal circumstances with reference to investment term, attitude to risk and capacity for loss;
- a statement bringing to the client's attention the need for periodic review of suitability (where relevant); and
- that a periodic report may be in the form of an update to and refer to a previous suitability report.¹⁴

Timescales for implementation

The MiFID II Directive and the Markets in Financial Instruments Regulation ("MiFIR") came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive into national law.

⁷ Article 54(11), MiFID II Delegated Regulation.

⁸ Article 54(7), MiFID II Delegated Regulation.

⁹ Article 54(2), MiFID II Delegated Regulation.

¹⁰ Article 54(7), MiFID II Delegated Regulation.

¹¹ Article 54(6), MiFID II Delegated Regulation.

¹² Article 54(6), MiFID II Delegated Regulation.

¹³ Article 54(1), MiFID II Delegated Regulation.

¹⁴ Article 54(12), MiFID II Delegated Regulation.

The changes to the MiFID Implementing Directive will be made by way of the MiFID II Delegated Regulation which will become effective by 3 January 2018. The MiFID II Delegated Regulation will have direct effect and the member states will not need to implement these changes into national law.

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