



European Securities and
Markets Authority

Consultation Paper

Guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **29 April 2021**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be subject to a request for public access to documents and disclosed in accordance with the relevant applicable framework. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading '[Data protection](#)'.

Who should read this paper?

This paper is primarily of interest to competent authorities and investment firms that are subject to Directive 2014/65/EU of the European Parliament and of the Council (MiFID II). In particular, this paper is addressed to investment firms and credit institutions providing investment services and activities, investment firms and credit institutions when selling structured deposits and external Alternative Investment Fund Managers (AIFMs) when providing investment services. This paper is also important for consumer groups, investors and trade associations, because the guidelines seek to implement enhanced provisions to ensure investor protection, with potential impacts for anyone engaged in the dealing with or processing of financial instruments.



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1 Executive Summary

Reasons for publication

In accordance with Article 16(2) of the ESMA Regulation, this paper sets out for consultation draft ESMA guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements. The MiFID II appropriateness and execution-only framework is an important element of investor protection in the case of the provision of services other than investment advice or portfolio management (“non-advised services”). It requires investment firms to ask a client for information on his knowledge and experience to assess whether the investment service or product envisaged is appropriate for him and to issue a warning in case the investment service or product is deemed inappropriate. The execution-only framework covers the exemption to this assessment, if certain conditions are met, including that the firm issues a warning to the client.

The purpose of these draft guidelines is to enhance clarity and foster convergence in the application of certain aspects of the appropriateness and execution-only requirements. This Consultation Paper builds on relevant parts from ESMA’s Guidelines on certain aspects of the MiFID II suitability requirements, while adjusting these to the appropriateness and execution-only framework. In addition, it takes into account the results of supervisory activities conducted by national competent authorities (NCAs) on the application of the appropriateness and execution-only requirements, in particular resulting from the 2019 common supervisory action (CSA) on appropriateness.

By pursuing the objective of ensuring a consistent and harmonised application of the appropriateness and execution-only requirements, the proposed guidelines will make sure that the objectives of MiFID II can be efficiently achieved. ESMA believes that the implementation of these guidelines should strengthen investor protection – a key objective for ESMA.

Contents

Section 2 explains the background of the proposals.

Annex I lists all the questions set out in the consultation paper; Annex II contains the cost-benefit analysis; and Annex III contains the full text of the draft guidelines.

Next Steps

ESMA will consider the responses it receives to this consultation paper in Q2 2021 and expects to publish a final report, and final guidelines, in Q3 2021.

2 Background

Overview

1. The MiFID II appropriateness and execution-only framework is an important element of investor protection in the case of the provision of services other than investment advice or portfolio management (“non-advised services”). This framework is set out in Article 25(3) of MiFID II and in Articles 55 and 56 of the MiFID II Delegated Regulation (as regards the appropriateness requirement), as well as Article 25(4) of MiFID II and Article 57 of the MiFID II Delegated Regulation (as regards the ‘execution-only’ exemption).
2. When providing ‘non-advised services’, firms are required to ask the client or potential client to provide information regarding his knowledge and experience relevant to the specific type of product or service offered or demanded so as to enable the firm to assess whether the envisaged investment service or product is appropriate for the client. Where the firm considers that the client does not have the necessary knowledge and experience to understand the risks involved in relation to the specific investment service or product offered or demanded, it shall warn the client accordingly. A warning is also required where a client or potential client does not provide the necessary information on his knowledge and experience, or where insufficient information is provided.
3. Articles 55 and 56 of the MiFID II Delegated Regulation further specify the information to be asked from clients and set out the record-keeping requirements.
4. Under certain conditions detailed in Article 25(4) of MiFID II, firms are allowed to provide non-advised services with respect to non-complex investment products without the need to conduct an appropriateness assessment. In this case, the firm should warn the client that it is not required to conduct an appropriateness assessment and that he therefore does not benefit from the corresponding investor protection.
5. It should be noted that while the described appropriateness and execution-only framework confirms the regime already applicable under MiFID I, some aspects of the requirements have been further strengthened in MiFID II. In particular, this regards record-keeping obligations related to appropriateness and an improvement of the conditions for the provision of services under the execution-only exemption.

Common supervisory action

6. In 2019, ESMA launched a so-called common supervisory action (CSA) on the application of the MiFID II requirements on the assessment of appropriateness. The 24 National competent authorities (NCAs) that participated in this CSA simultaneously carried out a review based on a sample of the firms under their supervision.
7. For this review, ESMA developed a common methodology, which included a list of questions for firms taken from ESMA’s supervisory briefing on appropriateness and

execution-only¹. Each of the participating NCAs selected a sample of firms, including credit institutions, that was meaningful in terms of the firms providing non-advised services in their jurisdictions, and conducted the review by making use of desk-based surveys and on-site visits. The CSA focused on the following key sections relating to the appropriateness and execution-only requirements:

- Determining when the appropriateness assessment is needed
 - Categorisation of financial instruments for the purpose of the appropriateness assessment
 - Obtaining information from clients on their knowledge and experience
 - Assessment of appropriateness
 - Statistics
 - Warnings to clients
8. Following the CSA, NCAs engaged in various types of follow-up actions, such as a publication of a report or a circular, updating national guidance on the appropriateness and execution-only requirements, direct follow-up with firms that were part of the sample, or sanctions.
9. Importantly, the CSA showed that there was insufficient convergence in the understanding and application of several areas of the appropriateness and execution-only requirements by firms in different Member States, and often within Member States themselves, creating problems for achieving a consistent level of investor protection in the EU. Therefore, ESMA decided to develop guidelines to enhance clarity and foster convergence in the application of certain aspects of the appropriateness and execution-only requirements.

Approach followed

10. While the level of investor protection afforded by the suitability assessment is higher compared to the appropriateness assessment and the execution-only exemption, they share some commonalities and requirements. This is particularly the case for the collection of information about the client's knowledge and experience and its assessment against the investment product or service in question.
11. Therefore, in developing the Consultation Paper on Guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements ("Consultation Paper"), ESMA has taken its Guidelines on certain aspects of the MiFID II suitability requirements² ("Guidelines on suitability") as a starting point. Guidelines on aspects such as 'know your client' and 'know your product' that are relevant for both the appropriateness and

¹ ESMA Supervisory briefing Appropriateness and execution only (Ref: ESMA35-36-1640).

² ESMA Guidelines on certain aspects of the MiFID II suitability requirements (Ref: ESMA35-43-1163).

suitability assessment have been adjusted to the appropriateness regime (and in some instances have also been updated based on supervisory experience as mentioned in following paragraph 12). Certain guidelines that were not relevant for the appropriateness assessment have been deleted, while others have been added on aspects not relevant for the suitability assessment (e.g. the effectiveness of warnings).

12. The following guidelines have been deleted or added in the Consultation Paper with respect to the Guidelines on suitability:
 - General Guideline 9 (Cost and complexity of equivalent products) and 10 (Costs and benefits of switching investments) of the Guidelines on suitability have been deleted;
 - Guideline 9 (Effectiveness of Warnings), Guidelines 12 (Determining situations where the appropriateness assessment is required), and Guideline 13 (Controls) have been added in the Consultation Paper.
13. In developing the Consultation Paper, ESMA has also drawn from the supervisory experience gained through the 2019 CSA and included some practical examples where relevant. ESMA is aware that some of these insights are equally relevant for the suitability assessment and should thus also be included in the Guidelines on suitability, for example relating to the assessment of a client's knowledge and experience or the categorisation of investment products, as well as those on controls. ESMA emphasises that it will take account of these insights in an upcoming review of the Guidelines on suitability. This review will take place after finishing the CSA on the application of the suitability requirements, launched in February 2020, in order to be able to take account of the insights of this CSA as well.
14. Given the close relationship of the 'execution-only exemption' with the appropriateness requirements, ESMA also decided to address the execution-only requirements in the Consultation Paper.

Guidelines on certain aspects of the MiFID appropriateness and execution-only requirements

Guideline 1 – Information to clients about the purpose of the appropriateness assessment

15. Guideline 1 clarifies how a firm providing non-advised services should, in good time, inform their clients or potential clients about the appropriateness assessment and its purpose.
16. In this context, firms should include a clear explanation that it is the firm's responsibility to conduct the appropriateness assessment, give information about situations where no assessment will be done and the consequences thereof for the client, and avoid confusion between advised and non-advised services by summarising the differences between these services. The aim is that clients understand the importance of providing the necessary information to the firm. Firms should avoid giving the impression that clients could refrain from submitting the information on their knowledge and experience.

17. It is emphasised that it is the responsibility of the firm, and not the client, to decide on the appropriateness of the investment service or product. Therefore, firms should avoid stating or giving the impression that the client takes this decision.
18. Firms should also carefully consider whether their written disclosures are designed to be effective, and ESMA provides some specific considerations for online services in this Guideline, such as emphasising relevant information or the possibility of having additional details for clients who are seeking further information.

Q1: Do you agree with the suggested approach on providing information about the purpose of the appropriateness assessment? Please also state the reasons for your answer.

Guideline 2 – Arrangements necessary to understand or warn clients

19. In this Guideline, ESMA clarifies that a firm should have policies and procedures to ask the client or potential client to provide all necessary information and that a firm should always aim to collect all necessary information to assess whether his knowledge and experience is appropriate to the specific type of services or product offered or demanded. ESMA highlights that this Guideline only clarifies the arrangements necessary to understand or warn clients; In Guideline 7, guidance is provided with respect to the necessary arrangements to understand investment products.
20. ESMA emphasises that firms should have policies and procedures in place that ensure that firms always ask clients for the necessary information on their knowledge and experience, and that they do not discourage clients in any way from providing this information. A warning that the firm is not in a position to determine the appropriateness of the investment service or product should thus only be given after all questions have been asked to the client and it turns out that the firm does not have the necessary information. Moreover, firms should encourage a client that has not provided the necessary information for the appropriateness assessment to provide this information anyway, for example by reminding the client of providing this information before each transaction.
21. Although it is up to firms how to ask the client to provide the information about a client's knowledge and experience, in practice, this is often done through a questionnaire or through discussions with the client. ESMA emphasises that these questionnaires should be fit for purpose and provides the most common reasons, to be considered by firms, why questions may not be understood correctly, based on insights from behavioural finance. Furthermore, specific factors are given for the design of questionnaires in the context of online services, which firms should consider when designing their questionnaires.
22. Questionnaires should enable the firm to obtain reliable information about a client's knowledge and experience in order to assess whether the client understands the essential characteristics and risks involved in relation to the investment service or product offered or demanded. Supervisory experience shows that there is a risk of circumvention if a firm allows a client to respond more than once to a questionnaire,

which could lead to the situation in which the information obtained is more a reflection of the client's ability of answering the questionnaire than of his actual knowledge and experience. It is therefore important that firms have policies and procedures in place to limit this risk of circumvention, for example by using cooling-off periods in which the client cannot re-take the questionnaire within a certain period of time.

23. ESMA emphasises that firms should take all reasonable steps to sufficiently assess their client's knowledge and experience related to the specific types of products offered by the firm. To address the risk of a client overestimating his knowledge and experience, it is particularly important that firms avoid self-assessment questions and balance these with objective criteria. Therefore, ESMA provides practical examples based on supervisory experience.

Q2: Do you agree with the suggested approach on the arrangements necessary to understand or warn clients? Please also state the reasons for your answer.

Guideline 3: Extent of information to be collected from clients (proportionality)

24. In Guideline 3, ESMA clarifies the application of the proportionality principle in the context of the appropriateness assessment as contained in Article 55(1) of the MiFID II Delegated Regulation. ESMA considers that the extent of information to be asked from clients may vary taking into account the type and characteristics of the investment products or services to be considered, the characteristics of clients and the client category.
25. The proportionality principle allows firms to apply the requirements in a proportionate manner, depending on the factors mentioned in the Guideline, while adhering to the objective of obtaining the necessary information on the client's knowledge and experience in order to assess whether he understands the essential characteristics and risks involved in relation to the investment service or product offered or demanded. It is emphasised that, although the extent of the information to be asked may vary, the level of protection afforded by the appropriateness assessment should remain unchanged.
26. Considering the type and characteristics of investment products, firms should ask for more in-depth information on a client's knowledge and experience when non-advised services are provided in relation to more complex or risky products as compared to less complex or risky products. After all, assessing a client's capacity to understand the risks associated with more complex or risky products will require more in-depth information from the client. It is important to clarify that in this context, ESMA is referring to complexity as a relative term.
27. This Guideline also clarifies situations where a firm should conduct an appropriateness assessment on the service when it intends to provide a non-advised service with specific features, and provides examples on bundled services and short selling. For example, if a firm intends to provide both execution services and the ancillary service of granting loans allowing the client to carry out the transaction, the appropriateness assessment should not only relate to the envisaged investment products, but also to the the ancillary service of granting loans and to the risks resulting from the combination of both.

28. Lastly, it is emphasised that, for the purpose of the appropriateness assessment, firms should only take into account a client's information on his knowledge and experience. It should be clear for clients that any other information collected (financial situation, investment objectives, ...) in the context of for example product governance arrangements or other investment services, will not be taken into account in conducting the appropriateness assessment.

Q3: Do you agree with the suggested approach on the extent of information to be collected from clients? Please also state the reasons for your answer.

Q4: Do you agree with the suggested approach regarding the appropriateness assessment relating to a service with specific features (paragraph 34 of the Guidelines)? In particular, do you agree with the examples provided (bundled services and short selling), or would you suggest including other examples? Please also state the reasons for your answer.

Guideline 4: Reliability of client information

29. Guideline 4 clarifies that a firm should take reasonable steps and have appropriate tools to ensure that the information provided by clients is reliable and consistent. While clients are expected to provide correct, up-to-date and complete information, firms should take necessary steps to check the reliability, accuracy and consistency of the information. If this is not the case, the firm should issue a warning in accordance with Article 25(3), third subparagraph, of MiFID II. ESMA emphasises that, to this end, the information should be viewed as a whole.

30. This Guideline specifically addresses situations where firms use tools such as questionnaires to conduct the appropriateness assessment. To ensure that these tools be fit for purpose and produce satisfactory results, firms should include adequate consistency controls.

31. ESMA also highlights the situation in which firms make use of pre-filled answers based on the client's transaction history with the firm. This information could either be collected through previous non-advised services, but also through advised services. Besides using objective, pertinent and reliable information, firms should in such a situation give clients the possibility to review the accuracy of this information and, if necessary, to correct and/or complete it.

Q5: Do you agree with the suggested approach on the reliability of client information? Please also state the reasons for your answer.

Guideline 5: Relying on up-to-date client information

32. In this Guideline, ESMA provides guidance on how a firm should ensure that the information about a client's knowledge and experience remains up to date. ESMA acknowledges that the issue of updating in the context of the appropriateness assessment has a different nature than for the suitability assessment, because the information on a client's knowledge and experience will tend to be less volatile than, for

example, information on a client's financial situation or investment objectives and knowledge and experience generally increase overtime. Still, firms should have procedures defining the frequency of updating information on a client's knowledge and experience collected previously in order to ensure that this information remains up to date, accurate and complete for the purpose of the appropriateness assessment.

33. At the same time, supervisory experience shows there is a risk of inducing the client to update his level of knowledge and/or experience so as to make a certain investment product appear appropriate that would otherwise be inappropriate for him. This would be evident in situations in which a client's profile has been updated too frequently or updates are concentrated in a short period of time. ESMA expects firms to take the necessary measures to mitigate this risk and provides practical examples to this end.

Q6: Do you agree with the suggested approach on relying on up-to-date client information? Please also state the reasons for your answer.

Guideline 6: Client information for legal entities or groups

34. In Guideline 6, guidance is provided on how the appropriateness assessment for legal entities or groups of clients should be conducted. This is particularly important for situations in which no representative is foreseen under applicable law. ESMA considers that firms should have a policy defining on an ex-ante basis how the assessment will be done in such situations. For example, in situations in which there are difficulties on choosing the person from whom the information on his knowledge and experience should be collected, firms should to adopt a prudent approach by considering the information on the person with the least knowledge and experience.

35. This Guideline builds on and refers to Guideline 6 of the Guidelines on suitability.

Q7: Do you agree with the suggested approach on client information for legal entities or groups? Please also state the reasons for your answer.

Guideline 7: Arrangements necessary to understand investment products

36. This Guideline deals with a firm's policies and procedures necessary to understand the characteristics, nature and features of investment products to allow them - following and building on the product governance arrangements - to assess if such products are appropriate to their clients.

37. In this context, firms should have reliable and objective procedures and tools to appropriately and proportionately consider the different characteristics and relevant risk factors of the investment products offered or demanded. The level of complexity of investment products is particularly important in this respect. In these procedures, the analysis conducted in the context of the firm's product governance arrangements should be taken into account, given the close relationship.

38. When categorising investment products for the purposes of the appropriateness assessment, it is important that firms use reliable, accurate, consistent and up-to-date

information. For more complex investment products, firms should not only rely on the information from external data providers but check and challenge such data where possible or compare data provided by multiple sources. Moreover, this information should be regularly reviewed.

39. In order to be able to assess whether the client understands the essential characteristics and risks involved in relation to the investment products that belong to a specific category, only products with sufficiently comparable characteristics and risk features should be grouped together. A sufficient level of granularity is thus key. Drawing from supervisory experience, ESMA lists multiple key factors that should be considered for this purpose.

Q8: Do you agree with the suggested approach on the arrangements necessary to understand investment products? Please also state the reasons for your answer.

Guideline 8: Arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning

40. This Guideline addresses the arrangements necessary to assess whether the client has the necessary knowledge and experience to understand the essential characteristics and risks involved in relation to an investment service or specific type of investment product. For this purpose, firms should have policies and procedures that take both sides into account and match both: first, the necessary information about the client's knowledge and experience, which should be considered holistically, and second, all relevant characteristics and risks of the investment products offered by the firm.
41. Supervisory experience shows that different methodologies can be used to determine the outcome of the appropriateness assessment and ESMA has therefore refrained from specifying certain methodologies in this Guideline. However, the methodology used should be clearly defined and documented by the firm.
42. Where firms rely on automated tools for the appropriateness assessment, they should have appropriate systems and controls to ensure that these automated tools are fit for purpose and produce satisfactory results. Several important aspects are highlighted with respect to the algorithms that determine the result of the appropriateness assessment, and firms should regularly monitor and test these algorithms.
43. To ensure objectivity and consistency with respect to the outcome of the appropriateness assessment, firms should have sufficient and unambiguous guidelines for relevant staff on how to perform the appropriateness assessment, preventing excessive discretion and allowing justifying their decision ex-post.

Q9: Do you agree with the suggested approach on the arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning? Please also state the reasons for your answer.

Guideline 9: Effectiveness of warnings

44. To ensure that clients are afforded with the envisaged protection of the MiFID II appropriateness framework, warnings issued to clients should be effective. Therefore, ESMA clarifies in Guideline 9 that these warnings should be clear and not misleading and that firms should also take reasonable steps to ensure that the warnings they issue are correctly received and understood as such, i.e. that the client will benefit from less or no protection if he requests to proceed with the transaction. Firms should clearly state the reason for issuing the warning to the client: either that no or insufficient information was provided by the client and that the firm therefore is not in a position to determine the appropriateness of investment service or product, or that the assessment of the information provided by the client shows that the investment service or product is inappropriate for the client. In this context, ESMA provides practical examples drawn from supervisory experience.
45. ESMA emphasises that firms should not downplay the importance of warnings and should not encourage the client to proceed with the transaction, to re-take the appropriateness assessment or to request an upgrade to professional client.
46. Supervisory experience shows that some firms offer clients without the necessary knowledge and experience educational tools, webinars or 'demo' trading platforms to enable them to improve their knowledge. Firms should always determine whether such a client indeed has the necessary knowledge with respect to a specific type of investment product by conducting another appropriateness assessment (focusing on the level of knowledge).
47. Lastly, where a firm's policies and procedures provide for the possibility to accept a client's request to proceed with the transaction after a warning has been issued, ESMA highlights important aspects that should be taken into account in ensuring that the firm acts in its client's best interests. Firms should identify ex-ante whether there are any conditions and criteria under which a client would not be allowed to proceed with a transaction after having received a warning, and ex-post to evaluate the overall effectiveness of warnings issued and make adjustments where necessary.

**Q10: Do you agree with the suggested approach on the effectiveness of warnings?
Please also state the reasons for your answer.**

Guideline 10: Qualifications of firm staff

48. Guideline 10 clarifies the requirement that a firm's staff involved in the appropriateness assessment have an adequate level of skills, knowledge and expertise.
49. For staff giving information about investment products, services or ancillary services to clients, ESMA refers to the obligation to possess the necessary knowledge and competence pursuant to Article 25(1) of MiFID II and further specified in the Guidelines for the assessment of knowledge and experience³.

³ ESMA Guidelines for the assessment of knowledge and competence (Ref: ESMA71-1154262120-153 EN (rev)).

50. Importantly, client-facing staff should be able to clearly distinguish between advised and non-advised services to clients and should have an adequate understanding of the respective legal requirements for each. In this context, firms should regularly train their staff.
51. Non client-facing staff involved in the appropriateness process should also possess the necessary skills, knowledge and expertise depending on their particular role, such as the setting up or the development of automated tools.

Q11: Do you agree with the suggested approach on the qualifications of firm staff? Please also state the reasons for your answer.

Guideline 11: Record-keeping

52. This Guideline clarifies the record-keeping requirements in relation to the appropriateness assessment pursuant to Article 56 of the MiFID II Delegated Regulation.
53. Firms should record all relevant information about the appropriateness assessment, such as information about the client and about the investment products offered to the client. The record-keeping arrangements should enable firms to track, on an ex-post basis, the result of the appropriateness assessment and its rationale, any warning issued to the client, whether the client has asked the firm to proceed despite the warning, and whether the firm accepted the client's request to proceed with the transaction.
54. ESMA highlights that the firm's record-keeping arrangements should enable the detection of failures and ensure that records kept are accessible for the firm and competent authorities.

Q12: Do you agree with the suggested approach on record-keeping? Please also state the reasons for your answer.

Q13: Do you see any specific difficulties attached to the requirement to keep records of any warnings issued and any corresponding transactions made by clients?

Guideline 12: Determining situations where the appropriateness assessment is required

55. Guideline 12 clarifies that firms should have appropriate arrangements to ensure that they are able to determine where an appropriateness assessment is to be performed. On the one hand, there should be a clear distinction between advised and non-advised services. On the other hand, where firms make use of the execution-only exemption when providing non-advised services with respect to non-complex products, they should be clearly able to distinguish which transactions legitimately fall under this execution-only exemption.
56. ESMA also clarifies that firms should have policies and procedures to ensure that conditions provided in Article 25(4) for providing an execution-only service are being met. Specifically, these policies and procedures should identify which of the investment products offered by the firm may be regarded as complex or non-complex. All investment



products that do not belong to those provided under Article 25(4)(a)(i-v) of MiFID II should be categorised as complex by default, unless the investment products as referred to in Article 25(4)(a)(vi) of MiFID II are assessed against all criteria of Article 57 of the MiFID II Delegated Regulation.

Q14: Do you agree with the suggested approach on determining situations where the appropriateness assessment is needed? Please also state the reasons for your answer.

Guideline 13: Controls

57. In Guideline 13, ESMA clarifies that firms should have appropriate monitoring arrangements and controls in place with regard to the appropriateness assessment.
58. Where firms use automated tools in the context of the appropriateness assessment, these tools should be monitored periodically to ensure that they remain fit for purpose. Moreover, firms should have arrangements to ensure that IT issues are identified in an early stage and that these tools cannot be circumvented by sales staff.
59. Where the appropriateness assessment is done through face-to-face meetings or by telephone, firms should include written or telephone records in their regular control processes to monitor whether sales staff comply with duties.
60. Lastly, ESMA highlights that firms should evaluate the overall effectiveness of the warnings issued to clients and should take account of this analysis and all other relevant information when conducting a regular review of the target market and distribution strategy of the relevant investment products.

Q15: Do you agree with the suggested approach on controls? Please also state the reasons for your answer.

Sustainable finance

On 8 June 2020, as part of its action plan on sustainable finance, the European Commission proposed integrating sustainability factors, risks and preferences into the product governance and the suitability requirements.⁴ In this context, ESMA invites market participants to express their views on whether sustainability factors and risks should be taken into account in the appropriateness assessment.

Q16: When providing non-advised services, should a firm also assess the client's knowledge and experience with respect to the envisaged investment product's sustainability factors and risks? If so, how should such sustainability factors and risks be taken into account in the appropriateness assessment? Please also state the reasons for your answer.

⁴ See also the European Commission's webpage: [Sustainable finance – obligation for investment firms to advise clients on social and environmental aspects of financial products \(europa.eu\)](https://ec.europa.eu/finance/press-releases/2020/06/08-2020-06-08-01_en.htm).

3 Annexes

3.1 Annex I - Summary of questions

- Q1: Do you agree with the suggested approach on providing information about the purpose of the appropriateness assessment? Please also state the reasons for your answer.**
- Q2: Do you agree with the suggested approach on the arrangements necessary to understand or warn clients? Please also state the reasons for your answer.**
- Q3: Do you agree with the suggested approach on the extent of information to be collected from clients? Please also state the reasons for your answer.**
- Q4: Do you agree with the suggested approach regarding the appropriateness assessment relating to a service with specific features (paragraph 34 of the Guidelines)? In particular, do you agree with the examples provided (bundled services and short selling), or would you suggest including other examples? Please also state the reasons for your answer.**
- Q5: Do you agree with the suggested approach on the reliability of client information? Please also state the reasons for your answer.**



- Q6: Do you agree with the suggested approach on relying on up-to-date client information? Please also state the reasons for your answer.**
- Q7: Do you agree with the suggested approach on client information for legal entities or groups? Please also state the reasons for your answer.**
- Q8: Do you agree with the suggested approach on the arrangements necessary to understand investment products? Please also state the reasons for your answer.**
- Q9: Do you agree with the suggested approach on the arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning? Please also state the reasons for your answer.**
- Q10: Do you agree with the suggested approach on the effectiveness of warnings? Please also state the reasons for your answer.**
- Q11: Do you agree with the suggested approach on the qualifications of firm staff? Please also state the reasons for your answer.**
- Q12: Do you agree with the suggested approach on record-keeping? Please also state the reasons for your answer.**
- Q13: Do you see any specific difficulties attached to the requirement to keep records of any warnings issued and any corresponding transactions made by clients?**
- Q14: Do you agree with the suggested approach on determining situations where the appropriateness assessment is needed? Please also state the reasons for your answer.**
- Q15: Do you agree with the suggested approach on controls? Please also state the reasons for your answer.**
- Q16: When providing non-advised services, should a firm also assess the client's knowledge and experience with respect to the envisaged investment product's sustainability factors and risks? If so, how should such sustainability factors and risks be taken into account in the appropriateness assessment? Please also state the reasons for your answer.**



3.2 Annex II - Cost-benefit analysis

1. The appropriateness and execution-only requirements are an important element of investor protection in the case of the provision of non-advised services to clients. This importance was already acknowledged under the MiFID I framework and has been confirmed under the MiFID II framework. Moreover, some aspects of the requirements have been further strengthened in MiFID II. In particular, this regards record-keeping obligations related to appropriateness and an improvement of the conditions for the provision of services under the execution-only exemption.
2. In light of the importance of the appropriateness and execution-only requirements for investor protection, ESMA decided to devote its first CSA to this topic in 2019. As explained in the background, this CSA showed there was insufficient convergence in the understanding and application of several areas of the appropriateness and execution-only requirements by firms in different Member States, and often within Member States themselves, creating problems for achieving a consistent level of investor protection in the EU. NCAs and firms would thus benefit from more guidance at ESMA level, increasing the level of protection provided to clients. Therefore, ESMA decided to develop guidelines to enhance clarity and foster convergence in the application of certain aspects of the appropriateness and execution-only requirements.
3. These draft guidelines aim to ensure a common, uniform and consistent implementation of the MiFID II requirements related to the assessment of appropriateness and to execution-only by providing explanations, clarifications and examples on how the relevant obligations should be fulfilled. By providing clarification of the relevant MiFID II appropriateness and execution-only requirements, ESMA is helping firms improve their implementation of these requirements. The draft guidelines also aim to ensure a convergent approach in the supervision of the appropriateness and execution-only requirements.

The impact of the draft ESMA guidelines

4. In light of the main objectives of these draft guidelines (extensively illustrated in the background), the following preliminary assessment aims at explaining the benefits and costs of the key policy choices that are presented for consultation.
5. It should be firstly observed that since the appropriateness and execution-only requirements are provided under MiFID II and the MiFID II Delegated Regulation, the impact of the proposed guidelines should be considered having in mind those legal provisions that they support. While market participants will likely incur certain costs for implementing these guidelines, they will also benefit from the increased legal certainty and the harmonised application of the requirements across Member States. Investors will in turn benefit from an improved assessment of whether their knowledge and experience is sufficient to understand the risks involved in relation to the envisaged investment service or product. The proposed guidelines should also facilitate competent authorities' efforts to improve the overall compliance with MiFID requirements increasing investor confidence in the financial markets, which is considered necessary for the



establishment of a genuine single capital market. Lastly, greater convergence leads to improved investor protection (consumer outcomes), which is a key ESMA objective.

Benefits

6. It is possible to illustrate the main benefits linked to the proposed guidelines as follows:
 - Reduction of the mis-selling risk and its related financial consequences. This is a major benefit for investors and for the financial markets as whole. In particular, firms will benefit from the reduction of complaints, costs of appeals and legal expenditure for tribunal cases, lack of reputation, fines, etc;
 - Reduction of risks related to regulatory or supervisory arbitrage due to an increased degree of harmonisation and more consistent supervisory convergence;
 - Positive effects from improved harmonisation and standardisation of the processes that firms have put in place when applying the appropriateness and execution-only requirements;
 - Positive effects from improved harmonisation and standardisation for competent authorities on the costs and activities needed to implement the new supervisory processes related to the appropriateness and execution-only requirements;
 - Increasing investors' confidence in financial markets.

Costs

7. With reference to the costs, it should first be reminded that the importance of the appropriateness and execution-only requirements has been already addressed to firms and competent authorities under the MiFID I regime as one of the pillars of the retail investor protection framework.
8. In light of what has been said, it can be reasonably expected that those firms having already in place a complete set of arrangements to comply with the MiFID II provisions are likely to incur less overall costs when implementing these guidelines.
9. ESMA considers that potential and incremental costs that firms will face when implementing the guidelines might be of both a one-off and ongoing nature, arguably linked to:
 - (direct) costs linked to the update/review of the existing procedural and organisational arrangements (e.g. the review and/or the update of the questionnaires and of the algorithms/models used to match the client's profile with appropriate investment products);
 - (direct) initial and ongoing IT costs; and



- (direct) relevant organisational and HR costs linked to the implementation of the guidelines providing clarifications on the qualification of firm staff (in particular compliance function staff and staff providing relevant investment services).

10. ESMA believes that the proposed options in this area provide the most cost-efficient solution to achieving the objectives of these guidelines.

Conclusions

11. In light of what has been illustrated above, ESMA believes that the overall (compliance) costs associated with the implementation of the proposed guidelines will be fully compensated by the benefits from the improved reliability of the information provided from and to investors and from the subsequent effectiveness of the appropriateness assessment. These benefits will interest all market participants, increasing the fundamental trust in the financial markets.

12. ESMA also considers that the proposed guidelines are able to achieve an increased level of harmonisation in the interpretation and application of the appropriateness and execution-only requirements across Member States, minimising the potential adverse impact on firms linked to compliance costs. As explained in the background, the benefits of more harmonisation have been stressed by the outcomes of the 2019 CSA, showing that there was insufficient convergence in the understanding and application of several areas of the appropriateness and execution-only requirements by firms in different Member States, and often within Member States themselves, posing problems for achieving a consistent level of investor protection in the EU. The harmonisation benefits will outweigh all associated costs in respect of these guidelines.

13. Finally, ESMA believes that the adoption of guidelines is the best tool to achieve the explained objectives since it further reduces the risk of diverging interpretations that might lead to discrepancies in the application and supervision of the relevant regulation and requirements across Member States (determining a risk of regulatory arbitrage and circumvention of rules). Moreover, the adoption of guidelines enables the creation of a cohesive and comprehensive document aimed at clarifying the appropriateness and execution-only process.

3.3 Annex III - Guidelines

I. Scope

Who?



1. These guidelines apply to:
 - a. Competent Authorities; and
 - b. Investment Firms.

What?

2. These guidelines apply in relation to Article 25(3) and (4) of MiFID II and Articles 55 to 57 of the MiFID II Delegated Regulation.

When?

3. These guidelines apply from [dd month yyyy] .

II. Legislative references and definitions

Legislative references

<i>ESMA Regulation</i>	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC ⁵
<i>MiFID II</i>	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 ⁶
<i>Delegated regulation</i>	Commission Delegated Regulation (EU) 2017/565 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 ⁷

Definitions

<i>Investment product</i>	A financial instrument (within the meaning of Article 4(1)(15) of MiFID II) or a structured deposit (within the meaning of Article 4(1)(43) of MiFID II).
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⁵ OJ L 331, 15.12.2010, p. 84.

⁶ OJ L 173, 12.06.2014, p. 349.

⁷ OJ L 87, 31.3.2017, p. 1.



Firms

Investment firms (as defined in Article 4(1)(1) of MiFID II) and credit institutions when providing non-advised services (within the meaning of Article 4(1)(2) of MiFID II), investment firms and credit institutions when selling structured deposits, external Alternative Investment Fund Managers (AIFMs) (as defined in Article 5(1)(a) of the AIFMD⁸) when providing the non-core service referred to in Article 6(4) (b) (iii) of the AIFMD).

Non-advised services

Investment services other than investment advice and portfolio management.

III. Purpose

4. These guidelines are based on Article 16(1) of the ESMA Regulation. The purpose of these guidelines is to clarify the application of certain aspects of the MiFID II appropriateness and execution-only requirements in order to ensure the common, uniform and consistent application of, respectively, Article 25(3) of MiFID II and of Articles 55 and 56 of the MiFID II Delegated Regulation as well as of Article 25(4) of MiFID II and of Article 57 of the MiFID II Delegated Regulation.
5. ESMA expects these guidelines to promote greater convergence in the interpretation of, and supervisory approaches to, the MiFID II appropriateness and execution-only requirements, by emphasising a number of important issues, and thereby enhancing the value of existing standards. By helping to ensure that firms comply with regulatory standards, ESMA anticipates a corresponding strengthening of investor protection.
6. These guidelines apply in full to all firms providing non-advised services, irrespective of the means of interaction with clients. The application of some guidelines is considered particularly relevant when the assessment is done online, due to the limited interaction (or none at all) between clients and firms' personnel. This is specifically pointed out in the text where relevant.

IV. Compliance and reporting obligations

Status of the guidelines

7. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants shall make every effort to comply with these guidelines.
8. Competent authorities to which these guidelines apply should comply by incorporating them into their national legal and/or supervisory frameworks as appropriate, including where particular guidelines are directed primarily at financial market participants. In this

⁸ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 01.07.2011, p.1-73).



case, competent authorities should ensure through their supervision that firms comply with the guidelines.

Reporting requirements

9. Within two months of the date of publication of the guidelines on ESMA's website in all EU official languages, competent authorities to which these guidelines apply must notify ESMA whether they (i) comply, (ii) do not comply but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.
10. In case of non-compliance, competent authorities must also notify ESMA within two months of the date of publication of the guidelines on ESMA's website in all EU official languages of their reasons for not complying with the guidelines.
11. A template for notification is available on ESMA's website. Once the template has been filled in, it shall be transmitted to ESMA.
12. Firms are not required to report whether they comply with these guidelines.

V. Guidelines on certain aspects of the MiFID appropriateness requirements

INFORMATION TO CLIENTS ABOUT THE PURPOSE OF THE APPROPRIATENESS ASSESSMENT AND ABOUT EXECUTION-ONLY

Relevant legislation: Article 24(1), 24(4), 24(5), 25(3) and 25(4) of MiFID II.

Guideline 1

13. **Firms should, in good time before the provision of non-advised services, inform their clients clearly and simply about the appropriateness assessment and its purpose which is to enable the firm to act in the client's best interest.**
14. ESMA considers that this should include the following:
 - A clear explanation that it is the firm's responsibility to conduct the assessment, so that clients understand the reason why they are asked by the firm to provide certain information and the importance of providing information that is up-to-date, accurate and complete;
 - Information regarding the situations where no assessment will be done (i.e. where the client does not provide the information requested or such information is not sufficient to conduct the appropriateness assessment or where services are provided under the execution-only exemption⁹) and the consequences thereof.

⁹ Investment services that only consist of execution or reception and transmission of client orders relating to investment products defined under MiFID as being 'non-complex'.

However, such information should avoid giving the impression that as a default option the client could refrain from submitting his information¹⁰;

- A summary of the differences between the requirements applicable to advised and non-advised services to avoid any confusion between these investment services.
15. It is up to the firms to decide how they will inform their clients about the appropriateness assessment. The format used to inform clients should however enable firms to keep records of the information provided.
16. Firms should avoid stating, or giving the impression, that it is the client who decides on the appropriateness of the investment service or product, or who establishes which service or product fit his own knowledge and experience. Any disclaimers (or other similar types of statements) aimed at limiting the firm's responsibility for the appropriateness assessment would not in any way impact the characterisation of the service provided in practice to clients nor the assessment of the firm's compliance with the corresponding requirements.
17. Provided that all the information given to clients complies with the relevant provisions (including obligations on the provision of information in durable medium), firms should also carefully consider whether their written disclosures are designed to be effective (e.g. the disclosures are made available directly to clients and are not hidden or incomprehensible). For firms providing online services in particular this may include:
- Emphasising the relevant information (e.g. through the use of design features such as pop-up boxes);
 - Considering whether some information should be accompanied by interactive text (e.g. through the use of design features such as tooltips) or other means to provide additional details to clients who are seeking further information (e.g. through a F.A.Q. section).

KNOW YOUR CLIENT AND KNOW YOUR PRODUCT

Arrangements necessary to understand or warn¹¹ clients

Relevant legislation: Articles 16(2) and 25(3) of MiFID II, and Article 55 of the Delegated Regulation.

Guideline 2

18. **Firms shall establish, implement and maintain adequate policies and procedures (including appropriate tools) to ask the client or potential client to provide information regarding that person's knowledge and experience investment field**

¹⁰ See also paragraph 27.

¹¹ See Guideline 9 on warnings.

relevant to the specific type of investment service or product offered or demanded as listed in Article 55(1) of the Delegated Regulation.

19. Firms' policies and procedures should aim to collect all information necessary to conduct an appropriateness assessment related to the specific product types that the firm offers for each client, while taking into account Guideline 3.
20. To that end, firms' policies and procedures should ensure that they do not abstain from asking information or discourage clients or potential clients in any way from providing information on their knowledge and experience.
21. It is up to firms to determine the means for asking the client to provide information on his knowledge and experience. They could use questionnaires (also in a digital format) completed by their clients or information collected during discussions with them to conduct the appropriateness assessment. In such cases, firms should ensure that the questions they ask their clients are specific enough and are likely to be understood correctly and that any other method used to collect information, such as the use of transaction data on certain types of products from an existing client to assess his experience, is designed to obtain the necessary information about the client's level of knowledge and experience. This is particularly important when firms are collecting the information through an online channel without any human interaction.
22. When designing the questionnaires aiming at collecting information about their clients for the purpose of an appropriateness assessment firms should be aware and consider the most common reasons why investors could fail to answer questionnaires correctly. In particular:
 - Attention should be given to the clarity, exhaustiveness and comprehensibility of the questionnaire, avoiding misleading, confusing, imprecise and excessively technical language (e.g. abbreviations);
 - Firms should give careful consideration to the layout and format of questionnaires and should avoid orienting investors' choices (e.g. font, line spacing...);
 - Collecting information on a series of items through a single question should be avoided;
 - Firms should carefully consider the order in which they ask questions in order to collect information in an effective manner;
 - In order to prevent a client from guessing and thus providing unreliable information, the client should be able to reply that he does not know how to answer the question.
23. When clients are allowed to respond to the questionnaire again after a first attempt that led the firm to conclude that the client does not have sufficient knowledge or experience, firms should have procedures and mechanisms in place to limit the risk of circumventing the requirements, making sure that the information collected remains reliable. For example, firms could consider limiting the number of attempts clients can perform within

a certain period of time, could work with different sets of questionnaires after a first “wrong attempt” by the client, could use a cooling-off period. Firms could also implement controls that ensure that a client cannot repeat the questionnaire several times to “test” what kind of answers are needed to get the desired outcome.

24. As it is the responsibility of the firm to aim for collecting the relevant information from clients, firms should take all reasonable steps to sufficiently assess their clients’ understanding of the main characteristics and the risks related to the specific types of investment products offered by the firm or at least to the product types in which the client has an interest. This includes an understanding of the relationship between risk and return on investments, for example by using questionnaires with multiple choice questions aimed at assessing the client’s real knowledge about the specific types of investment products.
25. In assessing knowledge and experience, firms should put in place mechanisms to ensure clients are not being asked to complete a self-assessment. Addressing the risk that clients may tend to overestimate their knowledge and experience and ensuring the consistency of the answers provided by the client¹² are particularly important for the correct assessment of the client’s knowledge and experience. Firms should, in particular, avoid using overly broad binary questions (yes/no) and/or a very broad tick-the-box approach when asking to the client whether he is familiar with the main characteristics and risks of specific types of investment products (for example, firms should avoid submitting a list of investment products to the client and asking him to indicate which products he understands). Self-assessment should be counterbalanced by objective criteria. For example:
 - Instead of asking whether a client understands the notions of risk-return trade-off of specific types of investment products, the firm should for instance question clients on some practical examples of situations that may occur in practice, for example by means of graphs or through positive and negative scenarios which are based on reasonable assumptions;
 - Instead of asking a client whether he has sufficient knowledge about the main characteristics and risks of specific types of investment products, the firm should for instance ask questions aimed at assessing the client’s real knowledge about the specific types of investment products, for example by asking the client multiple choice questions to which the client should provide the right answer;
 - Instead of asking a client whether he feels sufficiently experienced to invest in certain products, the firm should for instance ask the client what specific types of investment products the client is familiar with and how recent and frequent his trading experience with them is.

¹² See guideline 4.

26. In case of online services, firms should design their questionnaires taking into account factors such as:
- Whether the questions are sufficiently clear and/or whether the questionnaire is designed to provide additional clarification or examples to clients when necessary (e.g. through the use of design features, such as tool-tips or pop-up boxes);
 - Whether some human interaction/support (including remote interaction via emails or mobile phones) is available to clients when responding to the online questionnaire;
 - Whether steps have been taken to address inconsistent client responses (such as incorporating in the questionnaire design features to alert clients when their responses appear internally inconsistent and suggesting they reconsider such responses; or implementing systems to automatically flag apparently inconsistent information provided by a client for review or follow-up by the firm).
27. Firms should refrain from providing the client with a warning that they are not in a position to determine whether the envisaged investment service or product is appropriate for them without previously asking him information about his knowledge and experience. Firms should also abstain from emphasising that the client could proceed without such an assessment. Such a warning should only be issued after all questions have been asked and it turns out that the client refuses to provide information about his level of knowledge and experience or that the provided information is insufficient.
28. Where firms pre-fill answers based on the client's transactions history with that firm (e.g. through another investment service), they should ensure that only fully objective, pertinent and reliable information is used and that the client is given the opportunity to review and, if necessary, correct and/or complete each of the pre-filled answers to ensure the accuracy of any pre-populated information. Firms should also refrain from predicting clients' experience based on assumptions.

Extent of information to be collected from clients (proportionality)

Relevant legislation: Article 25(3) of MiFID II, and Article 55 of the Delegated Regulation.

Guideline 3

29. **In accordance with Article 25(3) of MiFID II, before providing non-advised services for which an appropriateness assessment is required, firms shall ask the client or potential client to provide information regarding that person's knowledge and experience in the investment field relevant to the specific type of investment service or product offered or demanded so as to enable the firm to assess whether the investment service or product envisaged is appropriate for the client. The extent of information asked may vary taking into account the type and characteristics of the investment products or services to be considered (i.e. level of complexity and risk of the investment products or services) and the client category (retail client or professional client).**

30. It is reminded that according to Article 56(1), second subparagraph of the MiFID II Delegated Regulation, a firm shall be entitled to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those particular investment services or transactions, or types of transaction or investment product, for which the client is classified as a professional client.
31. Although the extent of the information to be asked may vary, the level of protection afforded by the appropriateness assessment to clients must remain unchanged.
32. When providing access to more complex or risky investment products, firms should carefully consider whether they need to ask more in-depth information about the client's knowledge and experience than they would ask when less complex or risky investment products are at stake. This should enable firms to, on the basis of the answers provided, assess the client's capacity to understand the risks associated with such instruments. For such investment products with a high level of complexity or risk (for example, derivatives or leveraged products). Firms should carry out, on the basis of the answers provided, a reliable assessment of the client's knowledge and experience, including, for example, his ability to understand the mechanisms which make the investment product "more complex", whether the client has already traded in such products, the length of time he has been trading them for, etc.
33. Depending on the level of complexity of the investment products involved, the firm should assess the client's knowledge and experience more specifically than solely on the basis of the type to which the product belongs (e.g. subordinated debt instead of bonds in general).
34. When the firm intends to provide a non-advised service that has specific features, the firm should also, before such service is provided, conduct an appropriateness assessment relating to such specific features. This would for instance be relevant where a bundle of services or products is envisaged, for which, as required per Article 25(3) of MiFID II, the firm shall consider whether the overall bundled package is appropriate. For example, if a firm intends to provide both execution services and the ancillary service of granting loans allowing the client to carry out the transaction, this bundle of services will have different risks than each of the components considered in isolation. To take these differences into account when conducting the appropriateness assessment, it should not only relate to the envisaged investment products, but also to the ancillary service of granting loans and to the risks resulting from the combination of both. Another example would be a firm that enables clients to open a short position by selling an investment product. In this context, the firm should specifically assess whether the client has the necessary knowledge and experience to understand the risks involved in short positions.
35. For the purpose of the appropriateness assessment, firms should only take into account the information on the client's knowledge and experience. Firms should avoid giving the perception to clients that other information collected, in particular with regard to the client's financial situation and investment objectives, for other purposes (e.g. in the context of product governance or in the context of advised services to the same client), are taken into account when conducting the appropriateness assessment.



Reliability of client information

Relevant legislation: Article 25(3) of MiFID II, and Article 55(3), of the Delegated Regulation.

Guideline 4

36. **Firms should take reasonable steps and have appropriate tools to ensure that the information provided by their clients is reliable and consistent, without unduly relying on clients' self-assessment. If the information collected is not sufficiently reliable and consistent, this would amount to not having received sufficient information to conduct the appropriateness assessment and firms shall issue a warning to the client in accordance with article 25(3), third subparagraph, of MiFID II.**
37. Clients are expected to provide correct, up-to-date and complete information as is necessary for the appropriateness assessment. However, firms should take reasonable steps to check the reliability, accuracy and consistency of information collected about clients¹³. Firms remain responsible for ensuring they have the necessary information to conduct an appropriateness assessment or they should issue a warning to the client.
38. Where firms rely on tools to be used by clients as part of the appropriateness process (such as online questionnaires or software assessing whether an investment product is appropriate or if a warning should instead be issued, i.e. "profiling software"), they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. Firms should include consistency controls on the replies provided by clients in questionnaires in order to highlight contradictions between different pieces of information collected.
39. In order to ensure the consistency of client information, firms should view the information collected as a whole. Firms should be alert to any relevant contradictions between different pieces of information collected and contact the client in order to resolve any relevant potential inconsistencies or inaccuracies. Firms should ensure that the assessment of information collected about their clients is done in a consistent way irrespective of the means used to collect such information.

Relying on up-to-date client information

Relevant legislation: Articles 24(3) and 25(3) of MiFID II and Article 55(3) of the MiFID II Delegated Regulation.

Guideline 5

40. **Firms should adopt procedures defining the frequency of updating information on a client's knowledge and experience collected previously in order to ensure that**

¹³ When dealing with professional clients, firms should take into account the proportionality principles as referred to in guideline 3, in line with Article 56 (1), first subparagraph, of MiFID II Delegated Regulation.

the information remains up to date, accurate and complete for the purpose of the appropriateness assessment. The procedures should also specify how the information should be updated and what action should be taken by the firm when additional or updated information is received or when the client does not provide the information requested.

41. ESMA acknowledges that the issue of updating in the context of the appropriateness assessment has a different nature than for the suitability assessment, because the information on a client's knowledge and experience will tend to be less volatile than other elements of the suitability assessment, and knowledge and experience generally increases overtime. Therefore, the frequency for updating information on clients could be lower under the appropriateness regime than under the suitability regime. A particular attention should be given to the update of information for more vulnerable clients.¹⁴
42. In order to ensure that the appropriateness assessment is performed on the basis of reliable information about the client's knowledge and experience, firms should implement procedures to ask clients to inform them regularly of any change or update regarding the information originally provided. Firms should also have adequate procedures to deal with those situations where the client does not answer to their questions regarding changes or updates of the information provided initially.
43. Information could be updated, for example, by sending a questionnaire to clients or providing clients with the client information available to the firm and requesting confirmation that it remains accurate, complete and up to date. If in such a questionnaire, firms use pre-filled answers based on the client's transactions history with that firm, firms should ensure that only fully objective, pertinent and reliable information is used to pre-fill those answers and that the client has the possibility to review and, if necessary, correct each of the pre-filled answers and complete them. Relevant actions following updating might include changing the client's level of knowledge and experience based on the updated information collected.
44. In order to avoid relying on client information that is incomplete, inaccurate or out of date, firms should have arrangements in place to ensure that they ask the client to update the information on his knowledge and/or experience upon becoming aware of a relevant change that could affect his level of knowledge and/or experience. An example would be updating the information of the client's knowledge and/or experience where unusual transactions are registered on the client's account.
45. Firms should adopt measures to mitigate the risk of inducing the client to update his level of knowledge or experience so as to make a certain investment product appear appropriate that would otherwise be inappropriate for him, without there being a real modification in the client's level of knowledge and experience. An example of a good practice to address this type of risk is that a firm could adopt procedures to verify, before or after transactions are made, whether a client's profile has been updated too frequently or only after a short period of time from the last modification. Such situations would

¹⁴ Such as older clients could be.

therefore be escalated or reported to the relevant control function. To mitigate this type of risk, firms could also require, in cases where an update results in a higher level of knowledge and experience, that this change is reviewed and approved by two staff members. These policies and procedures are particularly important in situations where there is a heightened conflict of interest risk, e.g. in self-placement situations or where the firm receives inducements for the distribution of an investment product. Another relevant factor to consider in this context is the type of interaction that occurs with the client (e.g. face-to-face or through automated assessment).

Client information for legal entities or groups

Relevant legislation: Articles 16(2)25(3) of MiFID II.

Guideline 6

46. **Firms should have a policy defining on an ex-ante basis how to conduct the appropriateness assessment in situations where a client is a legal person or a group of two or more natural persons or where one or more natural persons are represented by another natural person. Such a policy should be drafted in accordance with the general guideline 6 and supporting guidelines enshrined in ESMA Guidelines on certain aspects of the MiFID II suitability requirements¹⁵.**
47. This implies, amongst others, that such a policy should make a clear distinction between situations where a representative is foreseen under applicable national law, as it can be the case for example for legal persons, and situations where no representative is foreseen, and it should focus on this latter situation. Where the policy allows clients to agree to designate a representative, they should be made aware clearly and in written form about the effects that such agreements may have regarding the protection of their respective interests. Steps taken by the firm in accordance with its policy should be appropriately documented to enable ex-post controls.
48. Where a representative is foreseen under applicable national law or is designated, information about knowledge and experience should be collected from that representative and the appropriateness assessment should be done with regards to that representative.
49. If the group of two or more natural persons involved have difficulties in deciding the person(s) from whom the information on knowledge and experience should be collected, the firm should adopt the most prudent approach by taking into account the information on the person with the least knowledge and experience. Firms should at least be prudent whenever there is a significant difference in the level of knowledge and experience of the different clients part of the group, or when the intended transaction may include leveraged investment products or contingent liability transactions that pose a risk of

¹⁵ ESMA Guidelines on certain aspects of the MiFID II suitability requirements (Ref: ESMA35-43-1163).

significant losses that could exceed the initial investment of the group of clients and should clearly document the approach chosen.

50. When a firm decides to ask information to assess the appropriateness for each individual client part of the group, the firm's policy should clearly specify how it will deal with those situations where there are significant differences between the level of knowledge and/or experience of those individual clients. Here again, the firm should adopt the most prudent approach by taking into account the information on the client part of the group with the least knowledge and experience. Alternatively, the firm's policy may also specify that it will not be able to assess the appropriateness in such a situation. In this context, it should be noted that collecting information on all the clients part of the group and considering, for the purposes of the assessment, an average profile of the level of knowledge and experience of all of them, would unlikely be compliant with the MiFID II overarching principle of acting in the clients' best interests.

Arrangements necessary to understand investment products

Relevant legislation: Articles 16(2) and 25(3) of MiFID II.

Guideline 7

51. **Firms should ensure that policies and procedures are implemented to understand the characteristics, nature and features of investment products in order to allow them to assess if such products are appropriate to their clients.**
52. For that purpose firms should adopt reliable and objective procedures and tools that allow them to appropriately and in a proportionate manner consider the different characteristics and relevant risk factors (such as credit risk, market risk, liquidity risk...) of the investment products offered or demanded. This should include taking into consideration the firm's analysis conducted for the purposes of product governance obligations¹⁶. In this context, firms should carefully assess how certain investment products could behave under different circumstances (e.g. convertible bonds which may, for example, change their nature into shares). Firms could also define, at the level of product governance arrangements, ex-ante limits to the range of investment products that can be offered under the appropriateness regime. For example, these limits could apply to investment products characterised by significant conflicts of interest (due to self-placement practices or to the payment of inducements) or to certain particularly complex or risky investment products.
53. Considering the level of 'complexity' of products is particularly important, and this should be matched with the client's information on knowledge and experience. Although complexity is a relative term, which depends on several factors, firms should – further to the assessment of products as complex or non-complex as required for the distinction between services that require an appropriateness assessment and those that do not -

¹⁶ In particular, MiFID II requires firms (under subparagraph 2 of Article 24(2)) to '*understand the financial instruments they offer or recommend*' in order to be able to comply with their obligation to ensure the compatibility between products offered or recommended and the related target market of end clients.

also take into account the criteria and principles identified in MiFID II, when defining and appropriately graduating the level of complexity to be attributed to investment products for the purposes of the appropriateness assessment.

54. Firms should adopt procedures to ensure that the information used to correctly classify investment products included in their product offer is reliable, accurate, consistent and up to date. Such procedures should take into account the different characteristics and nature of the investment products considered. For example, for more complex investment products with particular features, this may require more detailed processes and firms should, where possible, not solely rely on one data provider in order to understand and classify investment products but should check and challenge such data or compare data provided by multiple sources of information. In addition, firms should review the information used so as to be able to reflect any relevant changes that may impact the investment product's classification. This is particularly important taking into account the continuing evolution and growing speed of financial markets.
55. When categorising investment products for the purpose of the appropriateness assessment, firms should use a sufficient level of granularity to ensure that only investment products with sufficiently comparable characteristics and risk features are grouped together. Firms should consider multiple key factors for the categorisation (such as, for instance, optionality elements (in case of derivatives, or products with embedded derivatives); financial leverage; eligibility to bail-in; subordination clauses; observability of the underlying (e.g. the use of unfamiliar or opaque indices); guarantees of principal repayment or capital protection clauses; liquidity of the product (i.e. tradability on trading venues, bid-ask spread, selling restrictions, exit charges); and the currency denomination of the investment product).

MATCHING CLIENTS WITH APPROPRIATE PRODUCTS

Arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning

Relevant legislation: Articles 16(2) and 25(3) of MiFID II and Articles 21 and 56(1) of the MiFID II Delegated Regulation.

Guideline 8

56. **In order to assess whether an investment service or product envisaged is appropriate for the client, firms should establish policies and procedures to ensure that they consistently take into account:**
 - **all information obtained about the client's knowledge and experience necessary to assess whether an investment product is appropriate;**
 - **all relevant characteristics and risks of the investment products considered in the appropriateness assessment. Firms should establish policies and procedures enabling them to issue a clear and not misleading warning in case**

they consider that the investment service or product is not appropriate for the client or potential client.

57. A sale of an investment product that amounts to a disinvestment by the client should not trigger the necessity for firms to conduct an appropriateness assessment.
58. Firms that rely on automated tools when conducting an appropriateness assessment should have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results when matching the client's and investment product's characteristics.
59. In this regard, the tools should be designed so that they take account of all the relevant specificities of each client or investment product. For example, tools that classify clients (according to their level of knowledge and experience) or investment products too broadly would not be fit for purpose.
60. Firms should clearly define and document the applicable methodology used to determine the outcome of the appropriateness assessment. Where a firm uses a defined scoring system to grade and assess appropriateness, the methodology, metrics and formula used should be clear, unambiguous and documented.
61. When assessing – in the course of conducting an appropriateness assessment – a client's understanding of the main characteristics and risks of the specific types of investment products offered or demanded, a firm should consider the information that it has collected about the client's knowledge and experience altogether for the overall appraisal of his understanding of the investment products and of the risks involved in the envisaged transactions.
62. Relevant staff should have sufficient and unambiguous guidelines as to how to perform the appropriateness assessment, to ensure they do not have undue discretion when performing this assessment and to be in a capacity to justify their decision ex-post. Firms should ensure that tools and procedures adopted for the appropriateness assessment are designed in such a way that a client would not match with types of investment products for which the client's experience and/or knowledge has not been assessed or for which the client has not shown a sufficient level of knowledge and/or experience, and that a proper warning is issued accordingly.
63. In order to ensure the consistency of the appropriateness assessment conducted through automated tools (even if the interaction with clients does not occur through automated systems), firms should regularly monitor and test the algorithms that determine the appropriateness of investment products offered or demanded. When defining such algorithms, firms should take into account the nature and characteristics of the investment products included in their offer to clients. In particular, firms should at least:
 - establish an appropriate system-design documentation that clearly sets out the purpose, scope and design of the algorithms. Decision trees or decision rules should form part of this documentation, where relevant;

- have a documented test strategy that explains the scope of testing of algorithms. This should include test plans, test cases, test results, defect resolution (if relevant), and final test results;
- have in place appropriate policies and procedures for managing any changes to an algorithm, including monitoring and keeping records of any such changes. This includes having security arrangements in place to monitor and prevent unauthorised access to the algorithm;
- review and update algorithms to ensure that they reflect any relevant changes (e.g. market changes and changes in the applicable law) that may affect their effectiveness;
- have in place policies and procedures enabling to detect any error within the algorithm and deal with it appropriately, including, for example, suspending the provision of services if that error is likely to result in an inappropriate transaction and/or a breach of relevant law/regulation;
- have in place adequate resources, including human and technological resources, to monitor and supervise the performance of algorithms through an adequate and timely review of the services provided; and
- have in place an appropriate internal sign-off process to ensure that the steps above have been followed.

Effectiveness of Warnings

Relevant legislation: Article 25(3) of MiFID II, and Articles 55(2) and (3) and 56 (2) of the MiFID II Delegated Regulation.

Guideline 9

64. **To ensure its effectiveness, the warning issued by firms in case no information is provided by the client on his knowledge and experience or this is insufficient, or in case the assessment of such information shows that the investment service or product offered or demanded is not appropriate for the client, must be clear and not misleading.**
65. Firms should take reasonable steps to make sure the warnings they issue to clients are correctly received and understood as such. This could be done for example by using a different colour for the warning message from the rest of the information provided or, if the order is placed over the telephone, by asking clients whether they understand the content of the warning and the impact of such a warning (i.e. the fact that the client will benefit from less or no protection).
66. The warnings issued by firms should clearly state the reason for warning the client: either that no information was provided by the client or that the information collected is insufficient and that the firm therefore is not in a position to determine the

appropriateness of the envisaged transaction, or that the assessment of the information provided by the client shows that the envisaged transaction is inappropriate for the client. For example, ambiguous messages stating that the product is appropriate for “basic/intermediate/expert clients” should be avoided. Similarly, firms should avoid issuing warnings containing imprecise language (e.g. stating that the product or service “may not be appropriate” for the client), as they are unlikely to make the client sufficiently aware of the risks of proceeding with the transaction. Firms should also avoid overly long warnings that obscure the key message that the client does not have the necessary knowledge and experience for the investment service or product.

67. Firms should not downplay the importance of warnings and should not encourage the client to ignore them (e.g. during telephone conversations or in language used in the warning).
68. Firms should avoid the use of messages in the warnings that could encourage the client to proceed with the transaction, to re-take the appropriateness assessment or to request an upgrade to professional client. For example, firms could implement a process that the client needs to confirm that he is aware of the information provided in the warning before he can proceed with the transaction.
69. If a client who does not have the necessary knowledge and experience is offered educational tools, webinars or ‘demo’ trading platforms with the aim of improving his knowledge, the firm should, subsequently, determine that the client has the necessary knowledge regarding the envisaged investment service or product by conducting another appropriateness assessment focused on his level of knowledge. Such educational tools should not be structured in such a way that they specifically aim to improve the client’s ability to provide correct answers to a predefined set of questions as this may lead to a circumvention of the firm’s obligation to assess the client’s knowledge and experience of the investment products offered or demanded.
70. Where firms’ policies and procedures provide for the possibility to accept their clients’ requests to proceed with the transaction after a warning has been issued, firms should be reminded that they still have to comply with all other relevant requirements, including, amongst others, the obligation to act in their clients’ best interests and the product governance requirements for distributors.
71. In this context, firms should have policies and procedures identifying ex-ante whether there are any conditions and criteria under which a client would not be allowed to proceed with a transaction after having received a warning. For example, a firm could take into account situations where there is a heightened risk of conflicts of interest because the firm is selling its own investment products (or investment products issued by entities of the same group) or actively marketing investment products from within the firm’s range. Another factor that could be considered is a high level of complexity or risk of products offered or demanded. Furthermore, firms should evaluate the overall effectiveness of the warnings issued on an ex-post basis, for instance, by assessing the ratio of warnings that were followed by a transaction to the total of all warnings issued, and should make adjustments to their relevant policies and procedures where necessary.

OTHER RELATED REQUIREMENTS

Qualifications of firm staff

Relevant legislation: Articles 16(2), 25(1) and 25(9) of MiFID II and Article 21(1)(d) of the Delegated Regulation.

Guideline 10

72. **Staff involved in the appropriateness assessment should understand the role they play in this assessment and have an adequate level of skills, knowledge and expertise, including sufficient knowledge of the relevant regulatory requirements and procedures in order to discharge their responsibilities. This implies that firms should ensure that their client-facing staff are able to clearly distinguish between advised and non-advised services in practice and know which assessment needs to be performed (if any). To that end, firms should regularly train their staff.**
73. ESMA emphasises that staff giving information about investment products, investment services or ancillary services to clients on behalf of the firm must possess the necessary knowledge and competence required under Article 25(1) of MiFID II (and specified further in ESMA Guidelines for the assessment of knowledge and competence¹⁷), including with regard to the appropriateness assessment.
74. Other staff that do not directly face clients but are involved in the appropriateness assessment in any other way should still possess the necessary skills, knowledge and expertise required depending on their particular role in the appropriateness process. This may regard, for example, setting up the questionnaires, defining algorithms governing the assessment or other aspects necessary to conduct the appropriateness assessment and controlling compliance with the appropriateness requirements.
75. Where relevant, when employing automated tools (including hybrid tools), firms should ensure that their staff involved in the activities related to the development of these tools:
 - (a) have an appropriate understanding of the technology and algorithms used to conduct an automated assessment (particularly, staff should be able to understand the rationale, risks and rules behind the algorithms underpinning the automated assessment); and

¹⁷ ESMA Guidelines for the assessment of knowledge and competence (Ref: ESMA71-1154262120-153 EN (rev)).



- (b) are able to understand and review the automated assessment generated by the algorithms.

Record-keeping

Relevant legislation: Articles 16(6) and (7), 25(5) and 25(6) of MiFID II, and Articles 56 (2) and 72 of the Delegated Regulation.

Guideline 11

76. **As part of their obligation to maintain records of the appropriateness assessment referred to in Article 56 of the MiFID II Delegated Regulation, firms should at least:**
- **maintain adequate recording and retention arrangements to ensure orderly and transparent record-keeping regarding the appropriateness assessment, including the collection of information from the client and the non-advised service provided;**
 - **ensure that record-keeping arrangements are designed to enable the detection of failures regarding the appropriateness assessment;**
 - **ensure that records kept are accessible for the relevant persons in the firm and for competent authorities;**
 - **have adequate processes to mitigate any shortcomings or limitations of the record-keeping arrangements.**
77. Record-keeping arrangements adopted by firms should be designed to enable firms to track ex-post:
- the result of the appropriateness assessment and its rationale, i.e. a clear and straightforward link between the client information gathered and assessed and the outcome of the assessment;
 - any warning issued by the firm where the investment service or product was assessed as potentially inappropriate for the client, or where the client did not provide sufficient information to enable the firm to undertake an appropriateness assessment (irrespective of whether the client asked to proceed with the transaction or not);
 - whether the client asked to proceed with the transaction despite the warning; and
 - whether the firm accepted the client's request to proceed with the transaction in accordance with the related procedures adopted.

78. Therefore, a firm should record all relevant information about the appropriateness assessment, such as information about the client (including how that information is used and interpreted to define the client's knowledge and experience profile), and information about investment products offered to the client. Those records should include:
- any changes made by the firm regarding the appropriateness assessment, in particular any change to the client's knowledge and experience profile;
 - the types of investment products that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them.
79. Firms should understand the additional risks that could affect the provision of investment services through online or digital tools such as malicious cyber activity and should have in place arrangements able to mitigate those risks.¹⁸
80. Record-keeping arrangements adopted by firms may vary depending on the distribution channel used to provide non-advised services. For instance, firms should:
- where services are provided online, develop IT tools to track and store the information;
 - where services are provided by telephone, adopt appropriate arrangements to ensure that the firm is able to link any warning issued by it with a possible transaction made by the client who decides to proceed despite that warning;
 - where services are provided face-to-face, collect and record all relevant forms and documents used in the appropriateness process, in particular those signed by the client and/or the firm's staff.

Determining situations where the appropriateness assessment is required

Relevant legislation: Articles 16(2), 25(3) and (4) of MiFID II, and Article 57 of the Delegated Regulation.

Guideline 12

81. **Firms should adopt appropriate arrangements to ensure that they are able to determine situations where an appropriateness assessment needs to be performed and avoid performing one in situations where a suitability assessment needs to be performed.**
82. Firms should have procedures and controls in place regarding the interaction between sales staff and clients to guide and record the interaction and ensure that there is a clear distinction between advised and non-advised transactions on the one hand, and between

¹⁸ Firms should consider such risks not only in relation to the provisions stated in the guideline, but also as part of a firm's wider obligations under Article 16(4) of MiFID II to take reasonable steps to ensure continuity and regularity in the performance of investment service and activities, and corresponding delegated act requirements linked to this.

transactions falling within the execution-only exemption and other non-advised transactions.

83. Firms should have in place policies and procedures to ensure that the conditions provided in Article 25 (4) MiFID II for providing an “execution-only service” are being met where a non-advised service is provided and an appropriateness assessment is not conducted.¹⁹
84. Firms should design, implement and update policies and processes to identify which of their investment products may be regarded as “complex” and “non complex” for the purposes of the appropriateness requirements. Unless they have been assessed against and have met all the criteria of Article 57 of the MiFID II Delegated Regulation, all investment products that do not belong to the list provided under Article 25(4) of MiFID II should be categorised as complex by default.
85. Firms’ policies and processes should ensure that the investment products expressly excluded from the list of automatically non-complex instruments of Article 25(4) (a) of MiFID II are in any case not assessed against the criteria set out in Article 57 of the MiFID II Delegated Regulation to potentially be categorised as non-complex investment products for the purposes of the appropriateness assessment.
86. Firms should be able to trace whether a client has submitted his order in response to a personalised communication from or on behalf of the firm. In such cases, the firm should disqualify the transaction for the purposes of the “execution-only” exemption.

Controls

Relevant legislation: Articles 16(2), 16(5), second subparagraph, and 25(3) of MiFID II.

Guideline 13

87. **Firms should have appropriate monitoring arrangements and controls in place to ensure compliance with the appropriateness requirements. When firms rely on automated systems or tools in the appropriateness assessment process (e.g. client-profiling tools based on knowledge and experience, automatic warnings, or controls on complexity of investment products), these systems or tools should be fit for purpose and should be monitored periodically. Firms should keep records of this monitoring.**
88. When making use of automated controls in the context of the appropriateness assessment, firms should ensure that the automated controls cannot be circumvented by sales staff²⁰ and should periodically monitor the correct functioning of these

¹⁹ This does not prevent firms from carrying out an appropriateness assessment for all kinds of products, complex and non-complex.

²⁰ Or only in very specific circumstances set in the firm’s procedures and with specific hierarchical authorisation.



automated controls. Firms should have appropriate policies and procedures in place to detect IT issues at an early stage.

89. In the context of the appropriateness assessment, firms should pay particular attention to the complexity of investment products. For example, databases with complexity codes used for the appropriateness assessment tools should be reviewed on a regular basis and should be kept up to date.
90. When the appropriateness assessment is done through face-to-face meetings or by telephone, in which case a human intervention exists, firms should include written records from face-to-face meetings or telephone recordings in their regular control processes to monitor whether sales staff comply with their duties in the context of the appropriateness assessment. Firms should monitor these written records or telephone recordings as part of their control procedures.
91. Firms should monitor matters such as the ratio of warnings that were followed by a transaction to the total of all warnings issued in order to evaluate the overall effectiveness of the warnings issued. Firms should then use this analysis and all other relevant information when conducting a regular review of the target market and distribution strategy of the relevant investment products and make adjustments where necessary.