



CLERKIN LYNCH LLP

Central Bank focus on Investor Suitability under MiFID

Mark Browne

Partner and Head of Asset Management
and Funds at Clerkin Lynch LLP

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The Central Bank of Ireland (the “CBI”) recently issued a “Dear CEO” letter (the “Letter”¹) highlighting the requirements of firms under MiFID II to conduct an assessment of suitability when providing investment advice and/or portfolio management to ensure that related investments are aligned to the objectives and personal circumstances of investors, with the underlying aim being to protect investors from purchasing unsuitable products. The Letter highlights a range of shortcomings in related activities identified in practice amongst related firms, outlines the related expectations of the CBI and includes a requirement for all relevant firms to conduct a documented review of their related practices and have an action plan addressing any shortcomings approved by their boards.

Background

The Markets in Financial Instruments Directive (MiFID) was originally drafted in 2004 and became effective across the EU in 2007. As this pre-dated the financial crisis it became apparent over the passage of time that an updated version of this legislation would be appropriate to address some of the myriad issues raised by related events which regulators were seeking to tackle as well as general shortcomings which became evident in this initial legislation. The result was that MiFID II was drafted and became effective in 2018. This brought about significant changes to the existing regime concerning issues such as the supervisory powers of regulatory authorities, governance, the authorisation process, reporting, transparency and, of particular relevance for this article- the provisions relating to the conduct of business and investor protection. A key element of this latter aspect was the requirement to ensure client suitability when selling investments.

The European Securities and Markets Authority (“ESMA”) had issued relevant guidance² and a supervisory briefing³ on the suitability requirements but in light of concerns about inconsistent application of related rules across the EU, it determined to have a common supervisory action (“CSA”) conducted with the

national competent authorities (“NCAs”) across the EU on the application of the MiFID suitability rules and in particular those elements introduced by MiFID II. CSAs have become a useful mechanism to assist in fulfilling ESMA’s drive to build a common supervisory culture across the EU and ensure sound, efficient and consistent supervision. The aims of this one included gauging the application of relevant suitability requirements by intermediaries, ensuring consistency across the EU as well as enhancing investor protection. The CSA was conducted during 2020 by NCAs including the CBI and the findings as a whole were published by ESMA in its related report in July 2021⁴ (the “ESMA Statement”). In relation to the CBI, it engaged with all Irish authorised MiFID firms and Credit Institutions offering MiFID services and, following a desktop review, conducted detailed inspections of selected firms. It has now issued the Letter to provide further feedback and outline its related expectations from firms in scope.

¹ Dear CEO Letter, Consumer Protection- Investment Firms and Client Assets Division, Central Bank of Ireland, 1 December 2021

² “Guidelines on certain aspects of the MiFID II suitability requirements, Final Report”, ESMA, May 2018

³ “MiFID II Supervisory Briefing: Suitability”, ESMA, November 2018

⁴ “ESMA Public Statement on the findings from the 2020CSA on Suitability”, ESMA, July 2021



The Legislative Requirements

Article 25 (2) of the revised MiFID directive provides that when providing investment advice or portfolio management firms must obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and their investment objectives including risk tolerance so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for them and, in particular, are in accordance with their risk tolerance and ability to bear losses⁵.

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

Findings

The key findings of the CBI as detailed in the Letter include the need for firms to adopt a client-focussed approach, to ensure they have adequate procedures for the assessment of relevant client attributes (knowledge, experience, financial situation, and investment objectives), to ensure that suitability reports are sufficiently detailed and personalised and to have strict controls on processes for allowing exceptions.

The Letter also includes an Appendix giving examples of positive practices and inadequate practices relating to key themes relating to suitability including monitoring and oversight, training, vulnerable clients, disclosures, ensuring arrangements are put in place to

ensure product comprehension and the updating of suitability information. This further assists relevant firms in determining the approach to be taken to address related concerns and the policies and procedures to be put in place.

It can be noted that the findings of the CBI detailed in the Letter are to be read in conjunction with those of ESMA Statement and, while it does elaborate on certain of its findings, for example on ESMA Suitability General Guideline 7 regarding comprehension of investment products, it represents an additional level of detail of the applicable requirements and related regulatory expectations rather than an alternative. Accordingly ensuring full compliance will necessitate also adhering to the guidance from ESMA. Some examples of measures highlighted by ESMA which are not focused on in the Letter include: the need to ensure that controls and operational measures that have been adopted by firms to meet the MiFID II requirements are not circumvented and the full costs of investment products. This again underlines the need to ensure that all relevant guidance is used for reference purposes when devising appropriate policies and procedures to ensure compliance with this legislation.

Steps to Meet the Requirements

In order to ensure compliance with the terms of the Letter, firms would be advised to conduct a gap analysis comparing their current policies and procedures to those outlined and review them in light of the guidance available as well as the Letter. As the Appendix to the Letter includes practical examples of both positive and negative practices observed it would be appropriate to also conduct the analysis from both of these perspectives.

Key aspects of this analysis from the CBI's guidance in the Letter include requirements to:

⁵ 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



- Review documentation to ensure appropriate disclosures, disclaimers and terms are included.
- Operate an internal monitoring and oversight function separate to the business/sales side.
- Include policies and procedures to identify vulnerable clients and outline related actions.
- Adopt policies and procedures designed to ensure comprehension of investment products. Such procedures may include creating investment committees with compliance input.
- Prepare appropriate procedures for reviewing and updating client suitability, including detailing circumstances when blocks should be placed on accounts either as a standalone policy or as a distinct section of the overall client suitability assessment policy.
- Adequate training to include practical scenarios, with a minimum level of mandatory training for all relevant staff and training further tailored and adapted as required by practical developments including market volatility or new products.

Required Actions

The Letter includes an obligation for all MiFID Firms and Credit Institutions providing portfolio management and advisory services to retail clients to conduct and document a thorough review of their sales practices and suitability assessment procedures. This review should reflect not only the underlying legislative obligations but also the findings of the Letter and the ESMA Statement. In terms of timing, the review should have been completed so that an action plan can be discussed and approved by the

board by the end of Quarter 1 2022. The CBI further notes that in the course of any future supervisory engagement with relevant firms it may have regard to the level of consideration given by a firm to the obligations as set out in the Letter.

Implications for Fund and Manco Boards

While the Letter has been addressed to MiFID firms and not to the boards of funds it does have implications for them. CP86 clarified the responsibility of fund boards for distribution activities pertaining to units in their funds. Furthermore, the CBI has made it clear that while responsibility for fund related activities, including both management and distribution, can be delegated, overall responsibility for ensuring compliance does rest with the board. Accordingly, it would be appropriate for fund (and Manco where appointed) boards to get confirmation from their distributors that they were ensuring compliance with their obligations under MiFID, including the Letter and ESMA Statement, where appropriate. This requirement should also be extended indirectly to sub-distributors as appropriate. In practical terms, given the specific responsibilities of the MiFID firms addressed and related timeline, boards should obtain an updated confirmation making specific reference to ensuring compliance with related compliance obligations are being addressed in Q1 2022 (with a follow-on confirmation that any action plan approved has been implemented and is applicable on an ongoing basis) from the entity reporting to them (Manco or lead fund Distributor).

Following this original confirmation, this should form a standing item in the distribution report for board meetings. In addition, consideration should be given as to whether any distributors unaffected by the Letter (such as non-EU distributors appointed directly by the boards of self-managed funds, for example) should be required to comply with related obligations in order to ensure adherence to best practice across distribution activities of the fund uniformly.

How Clerkin Lynch Can Help

Clerkin Lynch can assist firms wishing to update their policies and procedures to ensure full compliance with their obligations under MiFID as a result of the Letter. This may include general consultancy services, undertaking a gap analysis of existing procedures or drafting policies, disclaimers and other relevant materials as necessary to ensure compliance. We can also assist fund boards or management companies with due diligence reviews on underlying distribution companies to ensure their compliance with the relevant MiFID obligations where appropriate.

About the Author

Mark Browne has in excess of 20 years legal experience advising on issues pertaining to UCITS. A frequently published author and speaker regarding issues relating to the financial services industry, including UCITS in particular, he has been recommended as a leading investment funds lawyer by The Legal 500 and Chambers & Partners (Europe and Global). Previous editions of Chambers Global noted that "he garners significant praise for launching UCITS funds and ICAVs, as well as handling the relevant regulatory issues with clients describing him as "terrific: he is responsive, almost always available and knowledgeable." and reported that clients stated "the amount of attention he gave us was outstanding," praising his "knowledge of how to get the deal done, and his great end product." He is recognised as a "notable practitioner" by IFLR1000, the guide to the world's leading financial law firms. He was previously named as 'Investment Fund Formation Lawyer of the Year in Ireland' in the CIM Global Awards and Investment Management lawyer of the year in Ireland by the Lawyer International's Legal 100 awards.



Author: Mark Browne

Partner and Head of Asset Management
and Funds at Clerkin Lynch LLP
Email: markbrowne@clerkinlynch.com
Phone: +353 1 611 4400