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Leading on Investments and Savings

**MiFID II -
Appropriateness
APPROACH TO
IMPLEMENTATION**

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1. Introduction

Where firms are selling Products on a non-advised basis, MiFID I requires them to take steps to determine whether those Products are appropriate for the consumer in question. In the UK, these requirements are included in Chapter 10 of COBS. MiFID II¹ makes changes to existing requirements, increasing the scope of Products for which an appropriateness assessment must be undertaken so that firms can determine a customer's or potential customer's knowledge and experience of specific product types or of services being sold. Appropriateness assessments will be required for some direct-offer or non-advised businesses, but are not when suitability is determined in advised or discretionary business.

As a result of the change from MiFID I to MiFID II the number of firms performing appropriateness assessments is likely to increase. This document sets out a recommended approach to performing such assessments, which may be of particular value to firms, subject to these rules for the first time. The aim of this paper is also to provide firms selling complex products with an assessment which is fair, consistent and not excessively onerous to implement.

This document is based on the MIFID II Directive and the relevant Delegated Regulation and is intended to complement rather than replace existing regulation and guidance, relating to pre-sale disclosure, product design and product governance. Different jurisdictions are required to transpose the MIFID II Directive into their own rulebooks. Firms should refer to the specific rules in the relevant rulebooks in local EU jurisdictions for further guidance. An appropriateness assessment should not be used to circumvent disclosures or to sell a Product into a target market for which it is not designed or suitable.

2. Scope

Appropriateness assessments apply to complex products (i.e. those not deemed to be non-complex) provided on a non-advised basis. UCITS products are deemed to be non-complex and will not require an appropriateness assessment. Other types of products sold on a non-advised basis that are deemed to be complex if certain criteria are met, will require that an appropriateness assessment be conducted irrespective of account type or wrapper. That

¹ The Directive on markets in financial instruments (MiFID 2) repealing Directive 2004/39/EC and the Regulation on markets in financial instruments (MiFIR)
http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm

being said, insurance-based investment and pension products are currently not in scope. However, the FCA is considering applying a consistent regulatory regime between these products and MIFID II investments² at another stage.

There is no exhaustive list of either complex or non-complex products. However, a Product which is not set up as a UCITS and which does not meet all of the criteria set out in Article 57 of the Commission Delegated Regulation³ will be deemed to be complex. Complex Products include those Products that incorporate a clause, condition or trigger that could fundamentally alter the nature of the risk of the investment or pay-out profile or that include explicit or implicit exit charges that have the effect of making the investment illiquid. (See Section 4 below for further information about the Article 57 criteria).

3. Application

MiFID II requires firms to maintain records of appropriateness assessments, but does not prohibit firms from selling Products to customers, or executing customer orders, where they determine that the Product may not be appropriate following the assessment, where the customer asks to proceed regardless. However, continuing to execute the order should not be automatic (having regard to the circumstances), and firms must first provide a relevant warning to customers in this case, or where the customer did not provide sufficient information to determine if the product is appropriate⁴. The warning should properly reflect the nature of the product (for example CFDs are complex, leveraged products where clients may risk losing more than their original investment. The FCA's recent Dear CEO letter identified several key areas of concern, in particular, the inability of some firms to assess appropriateness and to warn clients for whom CFDs are not appropriate).⁵

The appropriateness assessment can take place at the point of application or transaction depending on the preferred approach of the distributing firm.

Regardless of any exemption available, a firm may choose to perform appropriateness assessments when undertaking transactions in non-complex Products, or when opening

² FCA DP 15/3 Developing our approach to implementing MiFID II conduct of business and organizational requirements <https://www.fca.org.uk/news/dp15-03-mifid-ii-approach>

³ Commission Delegated Regulation 25.4.2016 C(2016) 2398 final -

<http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF>

⁴ COBS 10.3 <https://www.handbook.fca.org.uk/handbook/COBS/10/3.html?date=2016-03-21>

⁵ <https://www.fca.org.uk/static/documents/dear-ceo-letter-cfd.pdf>

customer accounts. The questions in this paper relating to general knowledge and experience may apply to such Products, but they are not the main focus of this paper.

4. Complex and Non-complex Products

MiFID II identifies certain categories of assets as automatically non-complex and therefore exempt from the requirement for appropriateness assessment. Article 25(4)(a) sets these out as follows:

Box 1: Article 25(4)(a)

“(i) shares admitted to trading on a regulated market or on an equivalent third-country market or on a multilateral trading facility (MTF), where those are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;

(ii) bonds or other forms of securitized debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

(iii) money-market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;

(iv) shares or units in UCITS, excluding structured UCITS as referred to in the second subparagraph of Article 36(1) of Regulation (EU) No 583/2010⁶;

(v) structured deposits, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the Product before term;

(vi) other non-complex financial instruments.”

⁶ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010R0583&from=EN>

To assess what could fall within the final category, “other non-complex financial instruments”, the Delegated Regulation applies a further six criteria which a financial instrument must meet to be deemed non-complex.

Box 2: Article 57

“A financial instrument which is not explicitly specified in Article 25(4)(a) of Directive 2014/65/EU shall be considered non-complex for the purposes of Article 25(4)(a)(vi) of Directive 2014/65/EU if it satisfies the following criteria:

- (a) it does not fall within Article 4(1)(44)(c) of, or points (4) to (11) of Section C of Annex I to Directive 2014/65/EU;
- (b) there are frequent opportunities to dispose of, redeem, or otherwise realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer;
- (c) it does not involve any actual or potential liability for the client that exceeds the cost of acquiring the instrument;
- (d) it does not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile, such as investments that incorporate a right to convert the instrument into a different investment;
- (e) it does not include any explicit or implicit exit charges that have the effect of making the investment illiquid even though there are technically frequent opportunities to dispose of, redeem or otherwise realise it;
- (f) adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.”

The list of non-complex Products is therefore open-ended; if a product meets all of the criteria presented in (a) through (f) above, it would be deemed non-complex.

5. Responsibility for assessing product complexity

Although the responsibility to conduct the appropriateness assessment for all complex products falls on the distributor, it would not be desirable for different distributors to treat the same product in different ways; that is if the criteria set out in the Delegated Regulation were inconsistently applied.

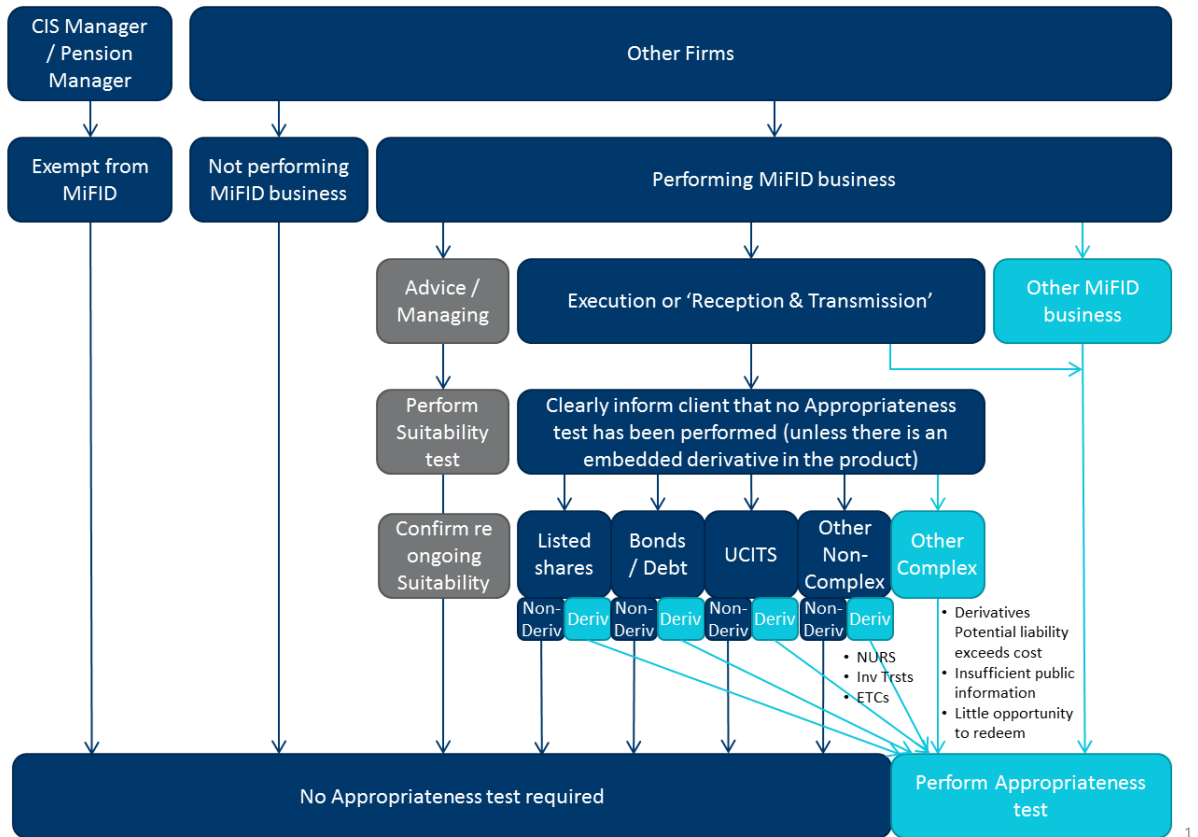
The onus is therefore on the Product's manufacturer to determine and communicate whether a Product is complex or not. This communication should include the reasons why a product is complex (if it is deemed to be so) with reference to the Article 57 criteria. We recommend this disclosure sits alongside the target market disclosures also required for MiFID II. The view of the manufacturer may, then, be reasonably relied upon by the distributor, so long as reasonable due diligence is undertaken by them.

ESMA has published Guidelines on complex debt instruments and structured deposits⁷ which provide examples of products which would be deemed to be complex and which would require an appropriateness assessment if they were sold on a non-advised basis. Please see Annex I for an extract from these Guidelines.

The following flowchart sets out the MiFID II appropriateness assessment requirements. The various categories are subject to ESMA's and FCA's further guidance on the "Other non-complex financial instruments" category.

⁷ ESMA's Final Report: Guidelines on complex debt instruments and structured deposits ESMA/2015/1783 - https://www.esma.europa.eu/sites/default/files/library/2015-1783_-_final_report_on_complex_debt_instruments_and_structured_deposits.pdf

Position under MiFID II



Instruments such as investment company shares, exchange traded funds and NURS structures will continue to be considered as non-complex, as they have been under the MiFID I regime subject to meeting the Article 57 criteria. Share classes such as convertible shares in split capital investment companies, subscription shares or warrants are likely not to meet the article 57 criteria and would thus be deemed complex.

6. General principles

The purpose of the appropriateness assessment is to determine that a customer has the necessary knowledge and experience to understand a complex Product and the features that make it complex. A good assessment should:

- be written in plain language and avoid the use of industry-specific technical terms without explanation;
- be brief enough to ensure the customer engages with the questions properly and is not encouraged to skip questions or falsify answers;

- address complexity and risk factors from the customer perspective and not that of the firm;
- be specific to the Product or Product group as appropriate.

An appropriateness assessment should aim to be media-neutral, so that it can be used in an on-line process, paper-based process or any other medium that a firm may choose.

7. Recommended Approach to Implementation

- Assessing Knowledge and Experience should consider:
 - A customer's experience in the particular Product or a similar Product which is complex under the same article 57 criteria. i.e. they may have previously purchased such a product;
 - The types of service, transaction and designated investments with which the customer is familiar;
 - The nature, volume, and/or frequency of the customer's transactions in designated investments and the period over which they have been carried out;
 - The profession or relevant former profession of the customer and related qualifications;
 - Knowledge/understanding of the cost of/barriers to exit;
 - Familiarity with material explaining the Product & its risks (such as Key Information Documents or similar).

The assessment of experience should be common to all Products. The “understanding” aspect, relating to complexity factors and exit risks will vary by Product though different Products may share one or more complexity factors.

The six Article 57 criteria, which describe “other non-complex Products”, are used to identify what knowledge should be demonstrated when a customer wishes to buy a complex Product, falling outside thereof in *one or more* category as defined in Box 2.

A Product which fails to meet one or more of the Article 57 criteria would require firms to assess appropriateness using the specific questions for each of the relevant criteria.

8. Experienced investors and grandfathering⁸

An assessment process should not impede investors from transacting in those products with which they are already experienced. Direct experience of a Product or applicable personal expertise (through work in the industry or relevant qualification) will often negate the need for further assessment.

A distributor may have pre-existing knowledge about a customer to satisfy an appropriateness assessment without reference to the customer, providing it is not aware that the information is manifestly out of date, inaccurate or incomplete. Examples of reliance may include knowledge that a customer already holds a Product or Product Type, has done so previously or that the customer is an investment professional. However, experience in one Product may not be applicable to a similar, but different, Product Type with comparable features.

Where a given Product is considered complex for the first time under MiFID II, existing customers who may have purchased a Product a considerable time ago may not be familiar with the Product's current risks and behaviours. In such cases, it may be inappropriate to assume knowledge and understanding based purely on prior purchases. Distributors should give thought to the level of presale disclosure and the period elapsed since the customer received information relating to the Product.

9. Appropriateness Assessment Question Bank

Where a product is complex, this document sets out questions which can be used by firms for determining appropriateness by assessing the customer's understanding of each relevant complexity category listed above.

9.1 General questions (automatically qualifying)

Answering "yes" to one of the following questions will be sufficient for the firm to determine that the product is not inappropriate for the customer. N.B. This is a lower standard of assessment than that which is required to demonstrate that the sale of an advised product is suitable.

⁸ COBS 10.2 <https://www.handbook.fca.org.uk/handbook/COBS/10/2.html?date=2016-03-21>

<p>1. Do you currently hold this investment or one of a similar type, or have you made an investment in this type of investment within the last twelve months?</p> <p>n.b. – to avoid confusion, the distributor should actively inform the investor of the type of product being purchased – i.e. “You are about to purchase a derivative”, or “You are about to purchase a structured product”.</p> <p>In some cases, firms may elect to use a different holding period if the nature of the risk is such that a 12-month period would not give the firm sufficient confidence in the customer’s understanding of the product. For example, complex or leveraged instruments such as CFDs.</p>
<p>2. Have you held this type of investment continuously for at least twelve months within the last five years?</p> <p>In some cases, firms may elect to use a different holding period if the nature of the risk is such that a 12-month period would not give the firm sufficient confidence in the customer’s understanding of the product. For example, complex or leveraged instruments such as CFDs.</p>
<p>3. Are you a financial services or investment professional with relevant experience, qualifications or knowledge of or about this investment type?</p>

The further questions below are to be asked only if the answer to all three of the above was “no” or “I don’t know” (which should be treated as “no”). The customer would have to answer all of the relevant questions in the sections below, correctly, for the firm to determine the product is not inappropriate for them. These questions have been based on fundamental Product Type elements.

In each case, the questions should be followed with a reminder to review the information specific to individual Products, such as the KIID/KID, Key Facts or other product-specific information.

9.2 Product Complexity related questions

The following sections set out the key areas where knowledge or understanding should be demonstrated by a customer. It is important that the questions posed are not a tick box exercise or one where an investor may simply give the same answer in the affirmative or negative to all questions in order to “pass” it. The exact way in which these questions should be posed, however, is at the discretion of the distributing firm, using language appropriate for its customer and the relevant products being sold.

#.	Art. 57 Complexity Attribute	Possible Products (not exhaustive or prescriptive)	Understanding to be demonstrated
A.	Product is a derivative or embeds a derivative	Options, futures, swaps, forward rate agreements, contracts for difference	Does the customer understand that they are investing in a derivative which is not asset backed and may carry increased counterparty risk?
B.	i) Infrequent opportunities to withdraw	Structured Products, Structured deposits,	Does the customer understand that there are only infrequent opportunities to dispose of, redeem, or otherwise realize that instrument, and that they may be tied in for prolonged periods without access to their capital?
	ii) Prices not publicly available or independently validated		Does the customer understand that withdrawals may only be made at prices that are not publicly available market prices or that not validated by independent valuation systems and that they are reliant on the Product Manufacturer to fairly apply the correct value?
C.	May lose more than they invest	Derivatives (category A)	Does the customer understand that there is actual or potential liability for the customer that exceeds the cost of acquiring the instrument and that they may be required to make good future losses greater than their original investment?
D.	Clause, trigger or conversion which changes risk and return profile	Split-Capital Investment Companies, Subscription Shares, Warrants, Convertible Loan Stock, other convertibles	Does the customer understand that the product incorporates a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile?
E.	Exit charges which may prevent early redemption or make the product illiquid	Products with low threshold gates Property funds Infrastructure funds	Does the customer understand the product has exit charges that may be a barrier to early redemption?
F.	Limited or very complicated product literature not intended for retail sale	Hedge funds	Does the customer understand that only limited information on the product is publicly available and is unlikely to be readily understood when making a judgment as to whether to enter into a transaction in that instrument?

10. Appropriateness assessment warnings

Where a firm determines that a product may not be appropriate for customers based on their responses, the customer should be given a warning to that effect. The warning should properly reflect the risks and nature of the Product, and firms must take a view on the degree to which the customer did not demonstrate sufficient understanding of the Product to satisfy the assessment prior to proceeding further.

A firm, on being unable to ascertain that product is appropriate may:

- Upon the client's request, permit the sale subject to appropriate warning and necessary disclosure (giving proper consideration to the above);
- prohibit the sale to a customer; or
- introduce a scaled response considering both the outcome of the assessment (including marginal results) and the complexity factors of a given Product.

The decision whether to continue with the sale is ultimately a matter for the firm, and should be considered under COBS 10.

The FCA's recent Dear CEO letter regarding CFDs⁹ addresses many of these considerations in further detail and examples of possible warnings relating to derivative products were given by ESMA in their investor warning document of February 2013.¹⁰

11. Record Keeping

ESMA's advice to the EU Commission¹¹ mandates the following:

Investment firms shall maintain records of the appropriateness assessments they have undertaken. These records should include:

- i. the result of the appropriateness assessment;
- ii. any warning given to the customer where the investment service or product purchase was assessed as potentially inappropriate for the customer, whether the

⁹ <https://www.fca.org.uk/static/documents/dear-ceo-letter-cfd.pdf>

¹⁰ <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-267.pdf>

¹¹ MIFID II Final Report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR. <https://www.esma.europa.eu/content/Technical-Advice-Commission-MiFID-II-and-MiFIR>
We are awaiting final publication in the Official Journal.

customer asked to proceed with purchase despite the warning and, if applicable, whether the firm accepted the customer's request to proceed with the purchase; and

iii. any warning given to the customer where the customer did not provide sufficient information to enable the firm to undertake an appropriateness assessment, whether the customer asked to proceed with purchase despite this warning and, if applicable, whether the firm accepted the customer's request to proceed with the purchase.

Annex 1

Non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the customer to understand the risk involved and complex structured deposits for the purpose of Article 25(4)(a)(ii), (iii) and (v) of MiFID II¹²

CATEGORY OF INSTRUMENT	(NON-EXHAUSTIVE) LIST OF EXAMPLES
<p>DEBT INSTRUMENTS EMBEDDING A DERIVATIVE</p>	<ul style="list-style-type: none"> a) Convertible and exchangeable bonds. b) Indexed bonds and turbo certificates. c) Contingent convertible bonds. d) Callable or puttable bonds. e) Credit-linked notes. f) Warrants.
<p>DEBT INSTRUMENTS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK</p>	<ul style="list-style-type: none"> a) Debt instruments the return of which is dependent on the performance of a defined asset pool. Examples: Asset-backed securities and asset-backed commercial papers, Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS), Collateralised Debt Obligations (CDOs) b) Debt instruments the return of which is subordinated to the reimbursement of debt held by others. Examples: <ul style="list-style-type: none"> - subordinated debt instruments; - certificates (as defined under Article 2(1)(27) of MiFIR). c) Debt instruments where the issuer enjoys discretion to

¹² In some cases, specific “types” of debt instruments have been identified, in other case a specific description has been provided. In some cases, a financial instrument could fall into more than one category.

	<p>modify the cash flows of the instruments.</p> <p>d) Debt instruments lacking a specified redemption or maturity date. Examples:</p> <ul style="list-style-type: none"> - perpetual bonds. <p>e) Debts instruments having an unusual or unfamiliar underlying. Examples:</p> <ul style="list-style-type: none"> - Debt instruments referencing underlying such as non-public benchmarks, synthetic indices, niche markets, highly technical measures (including price volatility and combinations of variables); - catastrophe bonds. <p>f) Debt instruments with complex mechanisms to determine or calculate the return. Examples:</p> <ul style="list-style-type: none"> - debt instruments structured in such a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument either because certain pre-determined threshold conditions are met or because certain time-points are reached. <p>g) Debt instruments structured in a way that may not provide for a full repayment of the principal amount:</p> <ul style="list-style-type: none"> - debt instruments eligible for bail-in tool purpose. <p>h) Debt instruments issued by a special purpose vehicle (SPV) in circumstances in which the name of the debt instrument or the legal name of the SPV may mislead the investors as to the identity of the issuer or guarantor:</p> <p>i) Debt instruments with complex guarantee mechanisms. Examples:</p> <ul style="list-style-type: none"> - Debt instruments with a guarantee mechanism where the trigger for the guarantee depends upon one or several conditions in addition to the default of the issuer; - Debt instruments with a guarantee mechanism where the level of guarantee or the actual trigger of the
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	<p>guarantee are subject to time limitations.</p> <p>j) Debt instruments with leverage features</p>
<p style="text-align: center;">STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE RISK OF RETURN</p>	<p>Structured deposits, in cases where:</p> <p>a) More than one variable affects the return received. Examples:</p> <ul style="list-style-type: none"> - Structured deposits where a basket of instruments or assets have to outperform a specified benchmark for a return to be paid; - Structured deposits where the return is determined by the combination of two or more indices. <p>b) The relationship between the return and relevant variable or the mechanism to determine or calculate the return is complex. Examples:</p> <ul style="list-style-type: none"> - structured deposits structured in a way that the mechanism under which the price level of an index is reflected in the return involves different market data points (i.e. one or more thresholds have to be met), or several index measurements at different dates; - structured deposits structured in a way that the capital gain or interest payable step up or down in certain specific circumstances; - structured deposits structured in a way that the anticipated revenue stream may vary frequently and/or markedly at different points of time over the duration of the instrument. <p>c) The variable involved in the calculation of the return is unfamiliar or unusual to the average retail investor. Examples:</p> <ul style="list-style-type: none"> - Structured deposits where the return is linked to a niche market, an in-house index or other non-public benchmark, a synthetic index, or a highly technical measure such as asset price volatility. <p>d) The contract gives the credit institutions the unilateral right to terminate the agreement before maturity</p>

<p style="text-align: center;">STRUCTURED DEPOSITS INCORPORATING A STRUCTURE MAKING IT DIFFICULT FOR THE CLIENT TO UNDERSTAND THE COST OF EXITING BEFORE TERM</p>	<p>Structured deposits, in cases where:</p> <p>a) An exit fee is not a fixed sum. Examples:</p> <ul style="list-style-type: none"> - structured deposits having a variable or “capped” exit fee (i.e. a fee up to 300 euros is charged in case of early exit); - structured deposits referring a variable factor such as an interest rate for the calculation of the exit fee. <p>b) An exit fee is not a fixed sum for each month remaining until the agreed term. Examples:</p> <ul style="list-style-type: none"> - structured deposits having a variable or capped exit fee per month remaining until the agreed term (i.e. a fee up to 50 euro per month in case of early exit). <p>c) An exit fee is not a percentage of the original sum invested. Examples:</p> <ul style="list-style-type: none"> - structured deposits having an exit fee that is at least equal to the amount of the returns accrued until the early exit date.
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