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Thematic inspection of appropriateness under MIFID II

Dear CEO,

The Central Bank of Ireland recently undertook a thematic inspection to review firms' compliance with the "appropriateness" requirements set out in the European Union's Markets in Financial Instruments Directive (MiFID II).

The Directive requires firms to complete a thorough and robust assessment of a client's knowledge and experience in order to determine whether the product or service is appropriate for that client. The correct application of the requirements is key to ensuring the protection of investors who are making investment decisions on complex products without taking investment advice. Investors purchasing such products without financial advice may be exposed to significant risk, as these products often have extremely complicated structures and features that make it difficult for clients to understand the associated risks.

Firms must issue a clear warning to the client if they consider that the product is not appropriate for that client. It is critical that clients are adequately warned when products are not appropriate, thus enabling them to make informed investment decisions.

The Central Bank's thematic inspection was part of a [Common Supervisory Action](#) initiated by the European Securities and Markets Authority (ESMA). This involved participant national competent authorities undertaking a review of a common investor protection topic.

Findings

The purpose of this letter is to provide feedback to industry on the findings of this inspection and to outline the Central Bank's expectations in relation to the assessment of appropriateness. The Central Bank noted some positive practices, but we also identified a number of concerns regarding firms' application of the appropriateness requirements (see Appendix below).

Firms failed to provide evidence that they are paying sufficient attention to the application of the appropriateness requirements, instead placing undue reliance upon standardised questionnaires and 'box-ticking' to demonstrate compliance. It was unclear whether firms were adequately considering the risks posed by the specific complex products they sell to retail clients on an execution-only basis.



Weak Processes, Systems and Controls

While firms generally have procedures detailing their appropriateness arrangements, in many cases firms failed to adhere to these procedures in practice. This resulted in errors, discrepancies and in some cases, firms assessed investments as appropriate on the basis of incomplete information. Internal processes and controls, including I.T. systems, must be sufficiently robust to ensure that procedures are adhered to in practice, with the result that errors and omissions are identified speedily and rectified efficiently.

Collection of information regarding knowledge and experience

The majority of firms used standardised questionnaires to gather information on the client's knowledge and experience. However, the questionnaires often failed to take account of the characteristics, risk or complexity of the proposed investment product. MiFID prescribes that information gathered should be to the extent appropriate to the 'type of product or transaction envisaged, including their complexity and the risks involved'. However, many firms are relying on a blanket approach for gathering client information that fails to consider the significant differences in risk and complexity among financial products.

The inspection highlighted that firms need to improve the quality of information collected and how it is used in the assessment of appropriateness.

Unclear rationale to support appropriateness decisions

In many cases, it was not clear how firms reached the decision that the product was appropriate for the client. We found completed assessments generally failed to explain how the client information gathered was applied in the assessment. Investment firms must document the rationale for concluding that a product is appropriate for the client, linking the information gathered and assessed to the outcome. All documentation relating to the appropriateness test should be maintained in line with firms' record-keeping arrangements. The inclusion of the explanation for the decision in appropriateness files should support the firm's own control functions, including compliance checking.

Weak Warnings

The inspection found evidence of inadequate warnings issued where products were assessed as being inappropriate for clients. The warning should state in clear, unambiguous language that the product or service is not appropriate for the client, and should act as an interruption in the process. The option to proceed with making an investment deemed to be inappropriate should not be presented as the 'next logical step' in the process. The client should be presented with the option of exiting the process. It is also the Central Bank's view that the appropriateness warning should not be viewed by firms as a 'disclaimer' which overrides the firms' obligations to act in the best interests of the client.



Actions

The Central Bank requires all firms to consider the contents of this letter and take all remedial action necessary to ensure they are acting in the best interests of consumers when selling complex products on an execution-only basis. In addition, we are engaging directly with those firms where mitigating action is required. The findings set out in this letter are not exhaustive, and firms should evaluate all processes relating to the provision of execution-only services to ensure they are providing the highest levels of investor protection.

The protection of consumers at the point of sale remains a key area of focus both for the Central Bank and ESMA. Continuing this theme, a [Common Supervisory Action on Suitability](#) is being undertaken in 2020.

The Central Bank will have regard to the contents of this letter when conducting future supervisory engagement.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Simon Sloan'.

Simon Sloan

Head of Division

Consumer Protection - MRI

Central Bank of Ireland



Appendix

Positive Practices

Positive practices identified throughout the inspection include;

- Separate business areas for the provision of advised and non-advised services, mitigating the risk of inadvertently providing investment advice for execution-only services.
- Use of automated questionnaires that automatically reject applications when required information on knowledge and experience is not populated.
- Use of product-specific procedures and guidance documents, setting out the product categorisation, key features, risks, and the expected levels of knowledge and experience investors should have for each product.
- Defined knowledge & experience thresholds based on the specific features, complexity and risk of a product, which are considered as minimum requirements for clients when assessing appropriateness.
- Clients required to demonstrate understanding of financial instruments and concepts by answering quiz questions relevant to the product or service, in line with [ESMA Guidance](#).
- Supporting narrative in relation to the determination of appropriateness, with a section included in appropriateness files detailing the rationale for the appropriateness decision.
- Layered approval and governance processes in place. In circumstances where a client was initially deemed inappropriate and wished to transact, approval required from senior management in order to proceed with the transaction.

Weak Practices

Weak practices identified throughout the inspection include:

- Weak warnings which did not sufficiently alert the client to the risks of proceeding with the transaction/nor act as an interruption to the process.
- In certain cases, where firms employed a defined scoring system, the underlying criteria for awarding points was questionable and/or unclear.
- Appropriateness files that were not completed in full, yet the application still proceeded. For example, where a client indicated experience in a specific instrument, key experience information on trading volume and frequency was often absent or incomplete.
- Use of generic information-gathering questionnaires across a broad range of financial instruments regardless of specific features, risk or complexity.