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Re: Suitability Themed Review

Dear CEO,

The Central Bank of Ireland (the "Central Bank") recently completed a themed review to examine the suitability processes of investment firms[1] (the "Firms"). Suitability is the process by which firms take all reasonable steps to ensure that a client's investments align to their investment objectives and personal circumstances. The review focused on the information-gathering phase of the suitability process and the Firms were assessed for compliance with the ESMA "Guidelines on certain aspects of the MiFID suitability requirements"[2] (the "Guidelines") which clarify the application of the suitability requirements outlined in Regulations 76(3) and 94 of the MiFID Regulations[3]. The purpose of this letter is to provide feedback on the Central Bank's findings.

Findings

The majority of inspected Firms failed to demonstrate full compliance with the Guidelines. Overall, the review highlighted that firms need to improve the quality of information collected and how they utilise this information in the suitability process. The review found that:

- Firms could not demonstrate that the documented suitability policies and procedures were implemented in practice.
- Client take-on application forms did not contain specific fields for the collection of required information and / or were found to be incomplete i.e. fields left blank.
- Not all firms could demonstrate that they had effective governance structures and appropriate tools to successfully implement and assess suitability. A number of firms relied

[1] MiFID firms, MiFID branches, AIFMs and UCITS Managers with Individual Portfolio Management.
[2] "ESMA Guidelines on certain aspects of the MiFID suitability requirements" ESMA/2012/387
https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-387_en.pdf
[3] European Communities (Markets in Financial Instruments) Regulations 2007 (S.I. No. 60 of 2007)

on client self-assessment of knowledge, experience and financial situation and failed to counterbalance self-assessment with an independent objective assessment.

- Dependencies on basic I.T. systems for the management of suitability processes increased the likelihood of human error and did not facilitate second line controls carrying out monitoring.
- Governance structures for the identification and treatment of vulnerable clients were absent or ineffective.

Where the Central Bank identified consumer risks, due to the issues outlined above, formal supervisory requirements were imposed on the relevant firms.

In firms where the suitability processes were most effective, the Guidelines were used as a foundation upon which to develop policies and procedures. Clear demonstration of adherence to the Guidelines was indicative of a strong culture of compliance and effective support structures embedded by the board. Good practices, which assisted some Firms in complying with the Guidelines, were identified during the review and these have been included in Appendix 1.

A feature noted in the inspected Firms was that a number of entities adopted different recommended asset allocations for a given risk appetite on the part of clients. The fact that such a divergence exists highlights the importance of firms clearly communicating to clients their specific investment offerings and house investment style. The provision of information assists clients in making an informed decision when selecting an investment firm.

MiFID II Preparedness

With less than five months remaining until MiFID II implementation, this review provided an opportunity to observe how firms were progressing with the significant challenge of preparing for MiFID II. As outlined in recent Central Bank published speeches on MiFID II[4], firms should be well advanced in their plans to implement the necessary changes and the responsibility for this lies with senior management and the board. The MiFID II regulations apply significant changes to the suitability requirements by placing a number of the Guidelines on a statutory footing and by introducing a number of new requirements, including suitability statements, annual suitability assessments and the need to ascertain additional information from clients in relation to risk tolerance and capacity for loss. This review revealed that best in class firms have completed detailed gap analyses and are in the process of implementing MiFID II.

[4] https://www.centralbank.ie/news-media/speeches

<u>Action Required:</u>

Boards must develop and maintain the appropriate governance frameworks in order to meet the regulatory suitability requirements on a continuous basis and embed a client centric culture within the firm. It is critical that the board has confidence that the policies and procedures it has approved are being implemented in practice and assessed via appropriate second line monitoring.

In the context of this suitability review, the Central Bank requires your firm to:

1. Review its suitability framework to ensure it meets and implements the relevant requirements and the Guidelines;
2. Take all necessary steps to ensure that the suitability policies and procedures are fully embedded within the firm; and
3. Consider all good practices listed in Appendix 1 against your firm's suitability framework and procedures. This could be part of your MiFID II implementation project.

The Central Bank expects that this letter will be discussed and considered by the board before 31 October 2017 and that the minutes of the relevant board meeting will record this. In circumstances of non-compliance by a firm with any regulatory requirements relevant to the matters raised in this letter, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and / or enforcement powers in respect of such non-compliance, have regard to the consideration given by a firm to the matters raised in this letter. Matters raised in this letter may also be considered during the conduct of future inspections.

Should you have any queries regarding the content of this letter please contact ams.mifid.conduct@centralbank.ie.

Yours sincerely

Denise Murray
Head of Asset Management Authorisations and Inspections

Appendix 1: Summary of Key Findings and Good Practices

During the review, the following key findings and good practices were noted in relation to the demonstration of compliance with the ESMA suitability guidelines.

Suitability Policies and Procedures, & Client Forms
Most relevant Guidelines: 2, 4 & 6
Finding: Firms could not demonstrate that the documented suitability policies and procedures were implemented in practice. Client take-on forms did not contain specific fields for the collection of required information and / or were found to be incomplete i.e. fields left blank. *Good Practices Identified:* • Firms adopt the principal of proportionality and have more detailed application forms for more complex portfolios. • Firms have embedded procedures for managing clients who insist on deviating from the firm's recommendations. • Additional information required under MiFID II, such as capacity and tolerance for loss, are already included in client take-on forms. • Questions in the client take-on form are drafted to prevent any distortion (either perceived or cognitive) which may impair the validity of the answer provided by the client.

Governance Structures
Most relevant Guidelines: 1, 3, 5 & 6
Finding: Not all firms could demonstrate that they had effective governance structures and appropriate tools to successfully implement and assess suitability. A number of firms relied on client self-assessment of knowledge, experience and financial situation and failed to counterbalance self-assessment with an independent objective assessment. *Good Practices Identified:* • Objectively assessing clients approach to risk using tools which factor in psychometric testing and risk profiling. Both proprietary and third party tools were used in the inspected firms. • Client take-on forms clearly and prominently highlight that the firm is gathering the necessary information in order to act in the client's best interest. • The ratio of clients to Client Relationship Manager is actively monitored to ensure that adequate resources are allocated to carry out the suitability process. • Embedding a suitability champion in the first line of defence to provide support to client facing staff.

Use of Technology
Most relevant Guidelines: 6, 8 & 9
Finding: Dependency on basic I.T. systems for the management of suitability processes increased the likelihood of human error and did not facilitate second line controls carrying out monitoring. ***Good Practices Identified:*** • Systems with pre-trade simulation of the impact of a proposed transaction on the overall client portfolio risk profile assists Client Relationship Managers in ensuring no unsuitable positions were purchased. • Automated triggers to ensure that suitability is assessed on at least an annual basis, as will be required under MiFID II. • Trading systems which have hard limits to block purchases of a specific class of security by a certain client risk profile i.e. riskier securities blocked from conservative client portfolios.

Vulnerable Clients
Most relevant Guidelines: 2, 3, 4, 6, 8 & 9
Finding: Governance structures (including clear policies and procedures) for the identification and safeguarding of vulnerable clients were absent or ineffective. ***Good Practices Identified:*** • Defining vulnerability broadly; not restricted to age and taking into account other factors such as personal circumstances and life changing events that could permanently or temporarily impact mental capacity or physical ability of clients. • Assessing vulnerability status on an ongoing basis as it is a status that is subject to change over time. • Recommending that vulnerable clients be accompanied to meetings by a trusted third party[5]. • Ongoing training to assist client-facing staff in identifying signs of potential vulnerability delivered by a relevant charity or through the use of vulnerable client scenarios.

[5] The 2010 Central Bank industry letter on "Suitability of Investment Products Sold to Older Consumers" also recommended that firms offer older clients the option of having a third party present at meetings. The industry letter can be found here