MiFID II

Appropriateness

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Hogan Lovells

Key Points

- Appropriateness assessments will be applied to new types of complex investments.
- New record-keeping requirements will apply where a firm makes an appropriateness assessment.

Appropriateness under MiFID II

Article 19(5) of the MiFID I Directive contains high-level obligations requiring firms to (unless they are assessing suitability) assess the appropriateness of complex instruments for a client before providing the relevant service. Under MiFID I, further detailed provisions are contained in Articles 36, 37 and 38 of the MiFID Implementing Directive.

In summary, the appropriateness rules require a firm, before carrying out a deal for a client in a complex instrument (such as a non-reality realisable security, a derivative or a warrant) to request information on the client's knowledge and experience and to assess the appropriateness of the investment for the client. Where the firm is not satisfied that the investment is appropriate, it must warn the client of this.

The high-level obligations in MiFID I are being changed by MiFID II in relation to the definition of complex instruments. The structure of the test in MiFID II defines "non-complex" instrument. An appropriateness assessment is required when for instruments which are not classified as non-complex. For simplicity, these are referred to as complex instruments. There is no specific test for complex instrument.

Most of the changes are in the form of amendments to provisions currently contained in Article 38 of the MiFID Implementing Directive. The revised requirements are set out in Article 57 of the MiFID II Delegated Regulation[1]. Section 3 of the MiFID II Delegated Regulation covers the assessment of suitability and appropriateness more generally, with Articles 55 to 57 dealing with appropriateness specifically.

The main changes being introduced by MiFID II are as set out below.

Clarification of criteria for complexity of instruments

The test for non-complex instruments in the MiFID II Directive includes a reference to "other non-complex financial instruments".[2] The criteria for "other non-complex financial instruments" are set out in Article 57 of the MiFID II Delegated Regulation. The structure of the test in the MiFID II Delegated Regulation clarifies that where an instrument is classified as complex under the MiFID II Directive, the criteria in the MiFID II Delegated Regulation cannot be applied to change this classification.

In practice, this means that an instrument which is not "non-complex" under the MiFID II Directive test does not need to be considered under the test in the MiFID II Delegated Regulation.

New types of complex instrument

In addition to listing the types of non-complex instrument contained in Article 38 of the MiFID Implementing Directive, Article 57 of the MiFID II Delegated Regulation includes two new types of structures in the scope of non-complex instruments. These are:

- instruments that do not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or payout profile.[3] This is likely to mean that a convertible security would be classified as a complex instrument; and
- instruments that do not include explicit or implicit exit charges that have the effect of making the investments illiquid even though technically frequent opportunities to dispose/redeem are possible[4]. This means that the practical impact of high exit charges

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1 Commission Delegated Regulation (EU) 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 ((the "**MiFID II Delegated Regulation**").

2 Article 25(4)(a)(vi), MiFiD II Directive.

3 Article 57(d), MiFID II Delegated Regulation.

4 Article 57(e), MiFID II Delegated Regulation.

could cause an instrument to be classified as a complex instrument.

ESMA Guidance on structures which "make it difficult for the client to understand the risks"

The MiFID II Directive includes the following structures in the scope of non-complex instruments:

- bonds or other securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those which "embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved" (see Article 25(4)(a)(ii));
- 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" (see Article 24(4)(a)(iii)); and
- structured deposits, excluding those with a structure "which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term" (see Article 25(4)(a)(v)).

ESMA has published guidelines for the assessment of whether financial instruments either "incorporate a structure which makes it difficult for the client to understand the risks involved" or "make it difficult for the client to understand the risk of return of the cost of exiting the product before term".[5]

The ESMA Guidelines give information about how these criteria should be applied and examples of structures which be considered to be complex instruments. The ESMA Guidelines should not be read as providing a list of all instruments which would meet the criteria. However, it does provide useful examples to explain the types of structures which MiFID II classifies as making an instrument complex.

Set out below are some of the types of debt instruments will be considered to be complex, as set out in the ESMA Guidelines (and therefore, these instruments are within the scope of appropriateness assessments):[6]

- debt instruments where the return is dependent on the performance of a defined asset pool;
- debt instruments where the return is subordinated to the reimbursement of debt held by others;
- debt instruments where the issue has discretion to modify cash flows (such as repayment of principal) of the instrument;
- debt instruments structured in a way that may not provide for a full repayment of the principal amount; and
- debt instruments which do not have a specific redemption or maturity date.

For structured deposits, the ESMA Guidelines list a number of characteristics which would indicate that an instrument is complex. In relation to a structure making it difficult for the client to understand the risk of return, these are:[7]

- more than one variable affects the return received; or
- there is a complex relationship between the return and the relevant variable or the mechanism to determine the return; or
- the variable used in the return calculation would be unusual or unfamiliar to the average retail investor; or
- the credit institution has unilateral rights to terminate the agreement before maturity.

The list of types of structures which would make it difficult for a client to understand the cost of exiting before term includes the following:[8]

- the costs are not a fixed sum; and
- the costs are not a fixed sum for each month (or part of month) until the end of the agreed term; and
- the costs are not a fixed percentage of the amount deposited.

5 ESMA, Guidelines: Guidelines on complex debt instruments and structured deposits, 4 February 2016 (ESMA/2015/1787) (the "**ESMA Guidelines**"). Further detail in ESMA, Final Report: Guidelines on complex debt instruments and structured deposits, 26 November 2015 (ESMA/2015/1783).

6 The full list is available at paragraph 13 of the ESMA Guidelines.

7 Paragraph 14 of the ESMA Guidelines.

8 Paragraph 15 of the ESMA Guidelines.

Record keeping

Firms must maintain appropriate records of appropriateness assessments, including the result of the assessment, any warning given, whether the client asked to proceed and whether the firm accepted this request.[9]

Timescales for implementation

The MiFID II Directive and the Markets in Financial Instruments Regulation ("**MiFIR**") came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive into national law.

The changes to the MiFID Implementing Directive will be made by the Commission by way of the MiFID II Delegated Regulation, which will become effective by 3 January 2018. The Delegated Regulation will have direct effect in Member States and so Member States will not need to implement these changes into national law.

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9 Article 56, MiFID II Delegated Regulation.

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