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Commentary on MiFID II conduct of business rules, Arts 21-30 MiFID II

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Chapter II – Operating conditions for investment firms

Article 21 – Regular review of conditions for initial authorisation

1. Member States shall require that an investment firm authorised in their territory comply at all times with the conditions for initial authorisation established in Chapter I.

2. Member States shall require competent authorities to establish the appropriate methods to monitor that investment firms comply with their obligation under paragraph 1. They shall require investment firms to notify the competent authorities of any material changes to the conditions for initial authorisation.

ESMA may develop guidelines regarding the monitoring methods referred to in this paragraph.

I. General Features

Purpose

1 Article 21 of MiFID II aims to safeguard effective supervision of investment firms.

II. Comment

2 MiFID II requires investment firms to comply on an ongoing basis with their authorisation requirements. The competent authorities[1] of the Member States must establish appropriate methods to monitor investment firms' compliance with the requirements of MiFID II. The monitoring methods were left to the discretion of the Member States under MiFID I, provided that the methods were suitable for effective supervision. Under Art 21 of MiFID II, investment firms contribute to effective supervision by notifying competent authorities of any material changes to the conditions needed for initial authorisation. When such a change is considered 'material' is not answered by Art 21. Under MiFID I, whether a change would be considered material was determined by the relevant competent authority. Under MiFID II, the European Securities and Markets Authority (ESMA) is empowered to develop guidelines regarding monitoring methods. Recital 44 of the MiFID II Delegated Regulation[2] indicates that outsourcing investment services or critical and important functions is capable of constituting a material change pursuant to Art 21(2).

Article 22 – General obligation in respect of on-going supervision

Member States shall ensure that the competent authorities monitor the activities of investment firms so as to assess compliance with the operating conditions provided for in this Directive. Member States shall ensure that the appropriate measures are in place to enable the competent authorities to obtain the information needed to assess the compliance of investment firms with those obligations.

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[1] Article 4(1)(26) of MiFID II.

[2] Commission Delegated Regulation (EU) 2017/565 of 25.4.2016 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 (OJ EU, L 87/1).

Article 23 – Conflicts of interest

1. Member States shall require investment firms to take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures.

2. Where organisational or administrative arrangements made by the investment firm in accordance with Article 16(3) to prevent conflicts of interest from adversely affecting the interest of its client are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf.

3. The disclosure referred to in paragraph 2 shall:

(a) be made in a durable medium; and

(b) include sufficient detail, taking into account the nature of the client, to enable that client to take an informed decision with respect to the service in the context of which the conflict of interest arises.

4. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to:

(a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;

(b) establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm.

I. General Features

1. Purpose

1 Conflicts of interest have the potential to disrupt the proper functioning of markets. Article 23 of MiFID II is intended to ensure, in particular, that investment firms are organised so that client interests are not adversely affected by conflicts of interest between the different activities of investment firms and the interests of their clients.[3] The key element of MiFID II's framework for addressing conflicts of interest is **management and avoidance of conflicts**; disclosure is a measure of last resort and not a means for managing

[3] Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 19.

conflicts of interest.[4] MiFID II significantly strengthens the conflicts-of-interest regulatory regime with respect to remuneration of staff and third-party payments and benefits. Even though Art 23 of MiFID II does not form part of MiFID II's section on investor protection, mitigating conflicts of interest is central to investor protection.[5]

2. Level 2 and 3 Measures

2 Relevant level 2 measures may be found in the following articles of the MiFID II Delegated Regulation: Art 27 (remuneration policies and practices), Art 33 (conflicts of interest potentially detrimental to a client), Art 34 (conflicts of interest policy), Art 38 (additional general requirements in relation to underwriting or placing), Art 39 (additional requirements in relation to pricing of offerings in relation to issuance of financial instruments), Art 40 (additional requirements in relation to placing), Art 41 (additional requirements in relation to advice, distribution and self-placement), Art 42 (additional requirements in relation to lending or provision of credit in the context of underwriting or placement), and Art 43 (record keeping in relation to underwriting or placing).

II. General (Art 23(1))

3 MiFID II abstains from providing a general definition of what constitutes a conflict of interest. The MiFID II Delegated Regulation comes close to providing a definition by stating in its Recital 45 that conflicts of interest typically arise when there is a conflict between the interests of the firm, or certain persons connected to the firm or the firm's group, and the interests of a client to whom the firm owes a duty; or when there is a conflict among the differing interests of two or more clients to whom the firm owes a duty. Recital 45 does not specify further what kind of duty a firm owes to a client, but it must be a duty to act in the interest of the client.[6] The duty referred to may be a fiduciary duty arising under contract or other national or EU law, as well as a duty imposed under

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[4] Commission, Public consultation: review of MiFID, 8 December 2010, 6.

[5] Stefan Grundmann and Philipp Hacker, 'Conflicts of interest' in Danny Busch and Guido Ferrarini (eds), *Regulation of EU financial markets: MiFID II* (Oxford University Press 2017) para 7.11.

[6] For further discussion see Christoph Kumpan and Patrick C. Leyens, 'Conflicts of interest of financial intermediaries' (2008) European Company and Financial Law Review 72, 83-84.

MiFID II.[7] A conflict of interest does not arise merely because a firm may gain a benefit unless there is potential harm to a client, nor because one client to whom the firm owes a duty may make a gain or avoid a loss, unless there is a concomitant potential loss for another client.[8]

4 Article 23 of MiFID II does not prohibit conflicts of interest. Instead, conflicts must be identified, prevented or managed, and disclosed. The corresponding ‘organisational requirement’ is Art 16(3) of MiFID II. Risks posed by conflicts of interest are further addressed by the MiFID II provisions governing remuneration (Art 24(10)) and third-party payments and benefits (Art 24(9)). The general principle of fair treatment in Art 24(1) also implicitly contains an obligation to avoid conflicts of interest. Preventing conflicts of interest is also one of the core responsibilities of the management body of an investment firm under Art 9(3). The rules to manage conflicts-of-interest apply to dealings with all clients of the relevant investment firm. Article 23(1) requires firms to take all ‘**appropriate steps**’ to identify and to prevent or manage conflicts of interests that arise in the course of providing investment services. It follows that firms must not go to disproportionate lengths to manage conflicts of interest, and that firms may take into account the nature of their business (including the services and financial instruments they offer), as well as the level of risk that conflicts of interest may adversely affect their clients.[9] Article 23(1) also expressly states that conflicts of interest may be caused by receiving inducements from third parties, or by a firm’s own remuneration and other incentive structures.

5 The requirements set forth by Art 23 are kept at a high level of abstraction and do not address any particular conflicts of interest generated by particular investment services. Each investment firm is required to take appropriate steps to manage its conflicts of interest based on its particular conflicts of interest risk profile. Portfolio management services, for example, generate significant conflicts of interest with respect to churning, front running and preferential treatment of more affluent clients. Article 33 of the MiFID II Delegated Regulation specifies situations which are potentially detrimental to a client and

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7 Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, 6.1.

8 Recital 45 MiFID II Delegated Regulation.

9 Jonathan Herbst, *A practitioner’s guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 94.

which an investment firm must take into account for the purpose of identifying conflicts of interest. Particular conflicts of interest that may arise in relation to specific investment services are also addressed by the MiFID II Delegated Regulation with respect to investment firms providing underwriting services or placing financial instruments (see Arts 38 through 43 of the MiFID II Delegated Regulation). These last-mentioned provisions ensure that the interests of investment firms or of their other clients do not improperly influence the quality of services provided to the issuer client.[10]

6 An investment firm must establish, implement and maintain an effective **conflicts-of-interest policy**. A firms must periodically assess and review, at least annually, its conflicts-of-interest policy and take all appropriate measures to address any deficiencies.[11] Article 34 of the MiFID II Delegated Regulation further requires certain content to be included in a policy and identifies procedures and measures which are necessary for a firm to ensure the requisite degree of independence that is appropriate considering its business activities, membership in a group of companies, and the risks faced by its clients. At a minimum, a conflicts-of-interest policy must identify the circumstances which constitute or may give rise to detrimental conflicts of interest, and it must specify procedures to be followed and measures to be adopted in order to prevent or manage such conflicts.[12] Article 34(3) of the MiFID II Delegated Regulation contains a non-exhaustive list of the procedures to be followed and measures to be adopted when it is necessary to ensure an appropriate degree of independence. An investment firm must pay special attention to certain activities in its policy if it, or a person directly or indirectly linked by control to the firm, performs a combination of two or more of the following activities: investment research and advice, proprietary trading, portfolio management and corporate finance business.[13]

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10 Recital 57 MiFID II Delegated Regulation.

11 Art 34(1), (5) MiFID II Delegated Regulation.

12 Art 34(2) MiFID II Delegated Regulation.

13 Recital 47 MiFID II Delegated Regulation.

III. Disclosure (Arts 23(2) and (3))

1 Article 23(2) of MiFID II contains a disclosure requirement where the organisational and administrative measures taken by an investment firm in accordance with Art 16(3) of MiFID II are not sufficient to ensure 'with reasonable confidence' that risks of damage to clients' interests would be prevented. Article 34(4) subparagraph 2 of the MiFID II Delegated Regulation further specifies the content of the required disclosure. Article 23(3)(b) requires disclosures to be **sufficiently detailed** in order to enable a client, considering the nature of the client, to make an informed decision with respect to the investment service in question before conducting business with the firm. A disclosure must clearly state that the organisational and administrative arrangements established by the relevant investment firm to prevent or manage the conflict of interest are not sufficient to ensure, with reasonable confidence, that the risks of damage to the interests of the client will be prevented.[14] A disclosure must include a specific description of the conflict or conflicts of interest that arise with respect to the investment service in question. This description must explain the general nature and sources of any conflict of interest, as well as the risks to the client resulting from a conflict of interest and the steps undertaken to mitigate these risks.[15] The disclosure must be sufficient for the average client within the relevant category of clients (e.g. professional or retail clients), not necessarily sufficient for a specific client, to make an informed decision with respect to a service. This interpretation of Art 23(3)(b) might be questioned, since the provisions refers to 'that client', indicating a greater need to personalise disclosures.[16] Yet, Art 23(3)(b) also refers to the 'the nature of the client', which means the professional or retail nature of a client and indicates that it is not necessary to consider a specific client's capability. The disclosure must mention and describe the specific conflicts of interest that would arise for the relevant type of client and specific investment service. It

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14 Art 34(4) subpara 2 MiFID II Delegated Regulation.

15 Art 34(4) subpara 2 MiFID II Delegated Regulation.

16 Stefan Grundmann and Philipp Hacker, 'Conflicts of interest' in Danny Busch and Guido Ferrarini (eds), *Regulation of EU financial markets: MiFID II* (Oxford University Press 2017) paras 7.49-7.52.

would be insufficient if a firm were to list all conflicts of interest that generally arise from its business across all client types and in respect of all services.

2 Like the MiFID I Implementing Directive, Arts 34(4) and (5) of the MiFID II Delegated Regulation favour ex-ante procedural controls over disclosure: Disclosure is a **measure of last resort** and over-reliance on disclosure would be considered a deficiency in an investment firm's conflicts-of-interest policy. Explicitly stating the principle that disclosure is to be a last resort aims to deter firms from over-relying on disclosure without adequately considering how conflicts of interest can be appropriately managed. What is considered as over-reliance is, however, not yet clarified at European level.

Foreword

1 Articles 24 through 30 contain MiFID II's harmonised **regime for investor protection**. The aim of the articles is to ensure an appropriate level of protection for investors, and to enhance the investor protection provided by MiFID I. Enhancing investor protection also supports MiFID II's 'passporting' regime, which is based on the principle of home-country supervision. Without such harmonisation, Member States could derogate from norms and undermine the free movement rights of investment firms.[17] Further, the investor protection measures ensure that investment firms conduct their business in a manner that sustains overall market integrity and efficiency.[18] Conduct that increases risk, or appears to, for clients may lead to loss of investor confidence[19] and, thus, may affect the efficient functioning of financial markets. Compared to MiFID I, there is only a small number of macro changes (e.g. product governance, see below paragraph 7 under Art 24), but a large number of micro changes which, taken together, **significantly reform** the regulatory regime for investor protection. Similarly, the investor protection measures in the MiFID II Delegated

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17 cf Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 23; Recitals 2, 3 MiFID II.

18 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 28.

19 Recital 5 MiFID II.

Regulation and the MiFID II Delegated Directive[20] build, to a large extent, on the obligations created by the 2006 MiFID I Implementing Directive, and selectively improve the latter directive. The new regime for investor protection, in particular the improved protection of professional clients and the product governance regime, is also a response to the most recent financial crisis and mis-selling scandals which were not prevented by MiFID I.[21] According to Recital 70 of MiFID II, the increasing complexity of financial services and instruments requires enhancing regulatory obligations for investment firms.

2 MiFID II's investor protection regulations primarily address market failures[22] that exist in retail markets using product design, distribution and disclosure rules. The changes to the protections for investors are particularly concerned with the distribution process and product governance, and may reflect experiences and (behavioural) research about the limits of disclosures in securing good investor outcomes.[23] **Empirical studies** on retail investor competence and decision-making show that retail investors in the EU are typically unsophisticated, have poor decision-making skills, struggle to understand disclosures and suffer from information overload, behavioural weaknesses and biases.[24] Yet, MiFID II only addresses these issues in the retail investment markets to a limited extent. The issue of information overload is rather exacerbated by MiFID II. For example, the improvements to the financial-advice regulatory regime are built on the traditional disclosure

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20 Commission Delegated Directive (EU) 2017/593 of 7.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (OJ EU, L 87/500)

21 Recitals 4, 5 MiFID II; ESMA/EBA/EIOPA, Joint Position on Manufacturer's Product Oversight & Governance Processes, November 2013, JC-2013-77, Annex 1; ESMA, Consultation paper: Draft guidelines on MiFID II product governance requirements, 5 October 2016, ESMA/2016/1436, 4, 17. For concerns about the quality of investment advice under MiFID I's regime see Synovate, Consumer Market Study on Advice within the Area of Retail Investment Services—Final Report, 2011.

22 For an overview see John Campbell et al, 'Consumer Financial Protection' (2011) 25 *J Econ Perspectives* 91-114; Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 770-771.

23 On the limits of disclosure see Omri Ben-Shahar and Carl Schneider, *More than you wanted to know: the failure of mandated disclosure* (Princeton University Press 2014).

24 BME Consulting, The EU market for consumer long-term retail savings vehicles, Final Report, 15 November 2007, 15; Decision Technology et al, Consumer decision-making in retail investment services: a behavioural economics perspective, Final Report, November 2010, 6-8.

concepts, and are intended to provide investors with all relevant information (see Recital 72 of MiFID II). MiFID II's ignorance of behavioural research is all the more surprising since the key investor information documents for UCITS[25] and for PRIIPs[26] target limited investor competence and decision-making skills. Whereas the UCITS and PRIIPs regulations collectively attempt to establish an effective disclosure scheme for retail markets by introducing summary disclosure documents, informed by behavioural research and with a focus on presentation and design, MiFID II's disclosure regime primarily identifies the types of disclosure which must be provided to clients. The **enhanced disclosure requirements** under MiFID II illustrate that mandated disclosure remains a key part of the investor protection framework.

3 The conduct-of-business rules apply to investment firms when they deal with retail or professional clients, unless the relevant provision specifies that it only applies in respect of retail clients (e.g. Art 25(6) below). Investment firms may, on their own initiative or at the request of a client, treat a person or entity otherwise defined as a professional client as a retail client (see Art 45(3)(b) MiFID II Delegated Regulation).

4 The MiFID II regulatory regime for investor protection does not obligate Member States to provide for civil law sanctions, with the exception of a single provision on private enforcement (see Art 75 below). Neither does MiFID II prohibit civil liability under national law in cases when an investment firm infringes its conduct-of-business rules. MiFID II does not harmonise the **conditions for civil liability** if an investment firm fails to comply with conduct-of-business rules, which is left to each Member State's civil law rules.[27] The CJEU has not yet answered if, and in what way, the conduct-of-business rules affect the conditions of civil liability when Member States decide to provide contractual remedies for non-compliance with MiFID II's conduct-of-business rules. The text of MiFID II is silent on this matter. Private law duties have not been

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25 Art 78 of Directive 2009/65/EC of the European Parliament and of the Council of 13.7.2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ EU, L 302/32).

26 Art 5(1) of Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26.11.2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ EU, L 352/1).

27 For MiFID I: Case C-604/11 *Genil v Bankinter* ECLI:EU:C:2013:344 para 57.

superseded by the investor-protection rules under MiFID II because the harmonisation of private law is outside the scope of MiFID II.[28] Further, private law duties owed by investment firms do not automatically follow regulatory duties since the former are principally determined by each Member State autonomously based on private law standards. Yet, it is not convincing that the balance between the interests of investment firms and their clients should be different only because a duty in one case stems from public law and in another case from private law. The private law standards should, therefore, be made more specific in such a way that legislative decisions regarding the content, scope and form of conduct-of-business rules under MiFID II must at least be taken into account. The conduct-of-business rules (indirectly) affect the scope and content of the private law duties. There are no private law principles which prohibit taking into account rules set out by MiFID II. In practice, private law duties will usually be consistent with investor protection rules under MiFID II. In **individual cases**, the private law duties may be more or less demanding than the public law duties.[29]

Article 24 – General principles and information to clients

1. Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.

2. Investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.

An investment firm shall understand the financial instruments they offer or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom it provides investment services, also taking account of the identified target market of end clients as referred to in Article 16(3), and ensure that financial instruments are offered or recommended only when this is in the interest of the client.

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28 The Commission's proposal to introduce a principle of civil liability of investment service providers in MiFID II (Commission, Public consultation: review of MiFID, 8 December 2010, 63) has not been adopted.

29 Martin Brenncke, *Regelung der Werbung im Bank- und Kapitalmarktrecht* (Schulthess & Nomos 2013) 1041-1047.

3. All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Marketing communications shall be clearly identifiable as such.

4. Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. That information shall include the following:

(a) when investment advice is provided, the investment firm must, in good time before it provides investment advice, inform the client:

  (i) whether or not the advice is provided on an independent basis;

  (ii) whether the advice is based on a broad or on a more restricted analysis of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided;

  (iii) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client;

(b) the information on financial instruments and proposed investment strategies must include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies and whether the financial instrument is intended for retail or professional clients, taking account of the identified target market in accordance with paragraph 2;

(c) the information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown shall be provided. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment.

5. The information referred to in paragraphs 4 and 9 shall be provided in a comprehensible form in such a manner that clients or potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis. Member States may allow that information to be provided in a standardised format.

6. Where an investment service is offered as part of a financial product which is already subject to other provisions of Union law relating to credit institutions and consumer credits with respect to information requirements, that service shall not be additionally subject to the obligations set out in paragraphs 3, 4 and 5.

7. Where an investment firm informs the client that investment advice is provided on an independent basis, that investment firm shall:

(a) assess a sufficient range of financial instruments available on the market which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met and must not be limited to financial instruments issued or provided by:

(i) the investment firm itself or by entities having close links with the investment firm; or

(ii) other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided;

(b) not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client must be clearly disclosed and are excluded from this point.

8. When providing portfolio management the investment firm shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client shall be clearly disclosed and are excluded from this paragraph.

9. Member States shall ensure that investment firms are regarded as not fulfilling their obligations under Article 23 or under paragraph 1 of this Article where they pay or are paid any fee or commission, or provide or are provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, to or by any party except the client or a person on behalf of the client, other than where the payment or benefit:

(a) is designed to enhance the quality of the relevant service to the client; and

(b) does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.

The existence, nature and amount of the payment or benefit referred to in the first subparagraph, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the investment firm shall also inform the client on mechanisms for transferring to the client the fee, commission, monetary or non-monetary benefit received in relation to the provision of the investment or ancillary service.

The payment or benefit which enables or is necessary for the provision of investment services, such as custody costs, settlement and exchange fees, regulatory levies or legal fees, and which by its nature cannot give rise to conflicts with the investment firm's duties to act honestly, fairly and professionally in accordance with the best interests of its clients, is not subject to the requirements set out in the first subparagraph.

10. An investment firm which provides investment services to clients shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. In particular, it shall not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs.

11. When an investment service is offered together with another service or product as part of a package or as a condition for the same agreement or package, the investment firm shall inform the client whether it is possible to buy the different components separately and shall provide for a separate evidence of the costs and charges of each component.

Where the risks resulting from such an agreement or package offered to a retail client are likely to be different from the risks associated with the components taken separately, the investment firm shall provide an adequate description of the different components of the agreement or package and the way in which its interaction modifies the risks.

ESMA, in cooperation with EBA and EIOPA, shall develop by 3 January 2016, and update periodically, guidelines for the assessment and the supervision of cross-selling practices indicating, in particular, situations in which cross-selling practices are not compliant with obligations laid down in paragraph 1.

12. Member States may, in exceptional cases, impose additional requirements on investment firms in respect of the matters covered by this Article. Such requirements must be objectively justified and proportionate so as to address specific risks to investor protection or to market integrity which are of particular importance in the circumstances of the market structure of that Member State.

Member States shall notify the Commission of any requirement which they intend to impose in accordance with this paragraph without undue delay and at least two months before the date appointed for that requirement to come into force. The notification shall include a justification for that requirement. Any such additional requirements shall not restrict or otherwise affect the rights of investment firms under Articles 34 and 35 of this Directive.

The Commission shall within two months from the notification referred to in the second subparagraph provide its opinion on the proportionality of and justification for the additional requirements.

The Commission shall communicate to Member States and make public on its website the additional requirements imposed in accordance with this paragraph.

Member States may retain additional requirements that were notified to the Commission in accordance with Article 4 of Directive 2006/73/EC before 2 July 2014 provided that the conditions laid down in that Article are met.

13. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients, including:

(a) the conditions with which the information must comply in order to be fair, clear and not misleading;

(b) the details about content and format of information to clients in relation to client categorisation, investment firms and their services, financial instruments, costs and charges;

(c) the criteria for the assessment of a range of financial instruments available on the market;

(d) the criteria to assess compliance of firms receiving inducements with the obligation to act honestly, fairly and professionally in accordance with the best interest of the client.

In formulating the requirements for information on financial instruments in relation to point b of paragraph 4 information on the structure of the product shall be included, where applicable, taking into account any relevant standardized information required under Union law.

14. The delegated acts referred to in paragraph 13 shall take into account:

(a) the nature of the service(s) offered or provided to the client or potential client, taking into account the type, object, size and frequency of the transactions;

(b) the nature and range of products being offered or considered including different types of financial instruments;

(c) the retail or professional nature of the client or potential clients or, in the case of paragraphs 4 and 5, their classification as eligible counterparties.

I. General Features

1. Purpose

1 Articles 24 and 25 set out the core conduct-of-business rules with which an investment firm has to comply when providing services to its clients. These rules are supplemented by the MiFID II Delegated Regulation and the MiFID II Delegated Directive. Conduct-of-business rules are one of the mainstays of investor protection as outlined by the Foreword to Art 24 MiFID II.

2. Level 2 and 3 Measures

2 Level 2 measures include the following provisions of the MiFID II Delegated Regulation: Art 27 (remuneration policies and practices), Art 36 (investment research and marketing communications), Art 38 (additional general requirements in relation to underwriting or placing, Art 39 (additional requirements in relation to pricing of offerings in relation to issuance of financial instruments), Art 40 (additional requirements in relation to placing), Art 41 (additional requirements in relation to advice, distribution and self-placement), Art 42 (additional requirements in relation to lending or provision of credit in the context of underwriting or placement), Art 43 (record keeping in relation to underwriting or placing), Art 44 (fair, clear and not misleading information requirements), Art 45 (information concerning client categorisation), Art 46

(general requirements for information to clients), Art 47 (information about the investment firm and its services for clients and potential clients), Art 48 (information about financial instruments), Art 49 (information concerning safeguarding of client financial instruments or client funds), Art 50 (information on costs and associated charges), Art 51 (information provided in accordance with Directive 2009/65/EC and Regulation (EU) No 1286/2014)), Art 52 (information about investment advice), Art 53 (investment advice on an independent basis), Art 58 (retail and professional client agreements), Art 64 (best execution criteria), Art 65 (duty of investment firms carrying out portfolio management and reception and transmission of orders to act in the best interests of the client), Art 67 (client order handling: general principles), Art 68 (aggregation and allocation of orders), and Art 69 (aggregation and allocation of transactions for own account).

3 Level 2 measures include the following provisions in the MiFID II Delegated Directive: Art 9 (product governance obligations for investment firms manufacturing financial instruments), Art 10 (product governance obligations for distributors), Art 11 (inducements), Art 12 (inducements in respect of investment advice on an independent basis or portfolio management services), Art 13 (inducements in relation to research).

4 Finally, the ESMA Guidelines on cross-selling practices, 11 July 2016, ESMA/2016/574 and the ESMA Guidelines on product governance, 2 June 2017, ESMA35-43-620 contain additional guidance for implementing MiFID II.

II. Best interest duty (Art 24(1))

5 Article 24(1) puts investment firms under an overarching obligation to act honestly, fairly and professionally in accordance with the best interests of its clients. It provides national competent authorities with an overarching mechanism for reviewing investment firm behaviour, for capturing emerging risks and for proactively addressing the asymmetry in bargaining power which characterises the firm-client relationship.[30] Article 24(1) is not exhaustively defined by Arts 24(2) through (12) and Art 25, and operates independently in

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[30] Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 800.

circumstances that are not addressed by Level 2 measures.[31] For example, providing advice about a type of financial instrument (**generic advice**[32]) is not considered giving investment advice for the purposes of MiFID II. However, if generic advice is provided prior to or in the course of providing investment advice, it forms an integral part of the investment service.[33] If an investment firm provides stand-alone generic advice to a client about a type of financial instrument which it presents as suitable for, or based on a consideration of the circumstances of, that client, and that advice is not in fact suitable for the client, or is not based on a consideration of his circumstances, the firm is likely to be acting in contravention of Art 24(1) or (3).[34]

6 Investment firms are not considered to be executing orders when they transmit client orders to other entities for execution, or when they provide portfolio management services and place orders with other entities for execution.[35] Yet, in order to comply with Art 24(1), investment firms providing these services must obtain the best possible result for their clients when **transmitting or placing client orders**, so that obligations similar to best-execution requirements under Art 27(1) apply.[36] In effect, investment firms providing these services must take all sufficient steps to choose the entities most likely to deliver best execution and monitor the performance of the entity or entities in this respect. These investment firms must establish and implement a **policy** that enables them to obtain the best possible result for their clients.[37] The content of these types of policies is further specified in Art 65(5) of the MiFID II Delegated Regulation, and the policy must be disclosed to clients under Art 65(6) of the MiFID II Delegated Regulation. The latter provision also stipulates further disclosure requirements with regard to the entity or entities chosen for execution, disclosures which closely resemble those required under

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31 Luca Enriques and Matteo Gargantini, 'The overarching duty to act in the best interest of the client in MiFID II' in Danny Busch and Guido Ferrarini (eds), *Regulation of EU financial markets: MiFID II* (Oxford University Press 2017) paras. 4.01-4.02.

32 Recital 15 MiFID II Delegated Regulation.

33 Recital 16 MiFID II Delegated Regulation.

34 Recital 15 MiFID II Delegated Regulation.

35 Art 65(8) MiFID II Delegated Regulation.

36 Art 65(3), (4) MiFID II Delegated Regulation.

37 Art 65(5) MiFID II Delegated Regulation.

the best execution regime. Article 65(7) of the MiFID II Delegated Regulation requires an investment firm to monitor the effectiveness of its policy and sets out the requirements for reviewing the policy, which are procedures also required under the best execution regime.

III. Product governance (Art 24(2))

7 Article 24(2) is part of the product-governance regime that MiFID II introduces. Article 24(2) applies to investment firms that create, develop, issue and/or design financial instruments for sale to clients (**product manufacturers**) and which offer or sell financial instruments to clients (**distributors**). The regulatory regime aims to avoid or reduce, from the early stages of a product's life cycle, any potential risks of failure to comply with investor protection rules.[38] The design, marketing and distribution of a financial instrument by an investment firm must be tailored to the **target market** of the financial instrument. A product manufacturer must design a financial instrument in such a way that it meets the needs of an identified target market of end clients within the relevant category of clients. The relevant category of clients refers to retail or professional clients. This requires a product manufacturer to identify the needs of the target market. Product manufacturers must further ensure that a distribution strategy is compatible with the target market, and that any distributor takes reasonable steps to ensure that a financial instrument is distributed to the identified target market (see paragraph 1 of Art 24(2)). Distributors must understand the financial instruments they offer or recommend, assess the compatibility of financial instruments with the needs of their clients considering a financial instrument's target market, and ensure that they offer or recommend financial instruments only if it is in the interest of the client (see paragraph 2 of Art 24(2)). If a client falls within the target market, this does not automatically mean that the financial instrument is suitable for a client.[39]

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38 Recital 15 MiFID II Delegated Directive.

39 Art 16(3) subpara 7 MiFID II.

1. MiFID II Delegated Directive

8 Articles 9 and 10 of the MiFID II Delegated Directive provide a detailed list of obligations that product manufacturers and distributors need to comply with in order to meet their product-governance obligations. The provisions also specify the **level of granularity** needed to define a target market and the criteria used to do so.

9 Product manufacturers and distributors must specify the ‘type(s) of client’ for whose needs, characteristics and objectives a financial instrument is compatible.[40] As part of this process, manufacturers and distributors must identify any group(s) of clients for whose needs, characteristics and objectives a product is not compatible (**negative target market**).[41] Type(s) of client means the group of clients that share common features important under the target market criteria. Personal features of individual clients are to be considered at the point of sale. ‘Type(s)’ of clients also indicates that a financial instrument can have multiple target markets, in particular when a differentiated distribution strategy is pursued. Distributors must appropriately identify and assess the circumstances and needs of clients they intend to sell to, so as to ensure that clients’ interests are not compromised as a result of commercial or other pressures.[42] A product manufacturer that does not contact clients directly can (initially) determine the target market based on theoretical knowledge of, and past experience with, the financial instrument or similar financial instruments, the financial markets, and the needs, characteristics and objectives of potential end clients.[43] A distributor which contacts clients directly, on the other hand, must use the information obtained from manufacturers and information about their actual clients to identify the target market.[44] Only one target market assessment is required if a firm acts as both manufacturer and distributor.[45]

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40 Art 9(9) subpara 1, Art 10(1) subpara 3, (2) subpara 1 MiFID II Delegated Directive.

41 Art 9(9) subpara 1, Art 10(2) subpara 2 MiFID II Delegated Directive.

42 Art 10(2) subpara 1 MiFID II Delegated Directive.

43 Art 9(9) subpara 2 MiFID II Delegated Directive.

44 Art 10(2) subpara 4 MiFID II Delegated Directive.

45 Art 10(2) subpara 4 MiFID II Delegated Directive.

10 If the manufacturer is not subject to the MiFID II product-governance regime, the relevant distributor which is subject to the MiFID II must independently define its target market, and must either obtain information from the manufacturer or use acceptable publicly available information, such as information disclosed in compliance with the Prospectus Directive, the UCITS Directive or the AIFM Directive.[46] The MiFID II Delegated Directive provides some criteria of a **target market assessment**: the financial instrument's (a) risk/reward profile must be consistent with the target market, (b) design must be driven by features that benefit the client, and (c) fee structure must be compatible with the needs of the target market, be appropriately transparent for the target market, and must not undermine the financial instrument's return expectations.[47]

2. ESMA's guidelines on product governance

1 ESMA's guidelines on product-governance[48] requirements mainly address target market assessments. In particular, the guidelines address (a) the criteria to be considered for identifying the target market, (b) the relationship between the distribution strategy and the definition of the target market, (c) methods to identify the negative target market, (d) application of the target market requirements in wholesale markets and (e) product distribution of products manufactured by firms not otherwise governed by MiFID II. ESMA also provides five very helpful case studies in the guidelines which illustrate how the requirements in the guidelines can be met.

2 ESMA lists **five categories** that manufacturers and distributors must evaluate in order to define the target market for a financial product: the type of clients to whom the product is targeted; knowledge and experience; financial situation with a focus on the ability to bear losses; clients' objectives and needs; and risk tolerance and compatibility of the risk/reward profile of the product with the target market. Since some of these categories are already used to conduct suitability or appropriateness tests (discussed further under Art 25 below), firms

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46 Art 10(1) subpara 2, (2) subpara 3 MiFID II Delegated Directive.

47 Art 9(11), (12) MiFID II Delegated Directive.

48 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620.

can use already existing information (in an abstract way) to identify the target market. The level of detail that is necessary with respect to any of the categories depends on the nature of the investment product and, in particular, its complexity and prevalence. For simple, **common products**, a target market can be identified in less detail than is needed for complicated or less common products.[49] ESMA also acknowledges that it is possible to adopt a common approach ("bulk target market") for financial instruments of one type with sufficiently comparable product features.[50] Based on a distributor's knowledge about its client base, distributors will often need to define a target market with more details than manufacturers, taking the relevant manufacturer's target market as a starting point.[51] Based on a distributor's client information, the distributor may broaden or restrict the target market or distribution strategy recommended by a manufacturer. Regarding the distribution strategy, a manufacturer should propose the type of investment service (advised or non-advised) through which the target market should usually acquire the financial instrument. If a product is deemed compatible for a sale without advice, the manufacturer must also specify the preferred acquisition channel (e.g. online).

3 Distributors that do not engage in advised sales may not have any information regarding their clients' financial situation, objectives, or knowledge and experience. It is to be welcomed that neither the MiFID II Delegated Directive nor ESMA's guidelines introduce burdensome additional requirements for **non-advised sales** at the point of sale through the back-door of the product governance regime. ESMA, in its guidelines, recognises that, depending on the type of investment service provided by a distributor, it may not be able to conduct a thorough target market assessment. Where a distributor only provides **execution-only services**, it is proportionate – and ESMA generally agrees with this view[52] – that the distributor can rely on the target market

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49 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, para 22. See also Recitals 18, 19 MiFID II Delegated Directive.

50 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, para 22.

51 For details see ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, paras 34-38, 42.

52 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, paras 40, 45-46.

assessment prepared by the manufacturer. That does not provide much clarity, however, because a provider of execution-only services will, due to a lack of client information, often not be able to assess whether a client falls within a manufacturer's target market. ESMA's guidelines indicate that the service can still be provided in such a case, but that a warning given to the client is necessary.[53]

4 ESMA clarifies that distributing a product **outside of its target market** is not prohibited. In certain cases, which should be justified by the individual facts of a case, deviations between the abstract target market assessment and an individual sale of a product are permissible if all other rules of conduct that apply at the point of sale are met. The reason for the deviation must be clearly documented. ESMA gives an example of a case where a sale may occur to a client outside the target market: when an investment adviser recommends a product which would normally be too risky considering a client's profile, but recommends the product for diversification purposes, and where the suitability requirements are fulfilled (see discussion under Art 25(2) below for additional information).[54] ESMA also distinguishes between the positive target market, the negative target market and the area in between. A sale inside the negative target market shall be more difficult to justify than a sale that is merely outside the positive target market. A sale inside the negative target market must also be disclosed to the client.[55]

IV. Information to clients (Arts 24(3) through (6))

1. Information and marketing communications

5 Article 24(3) of MiFID II governs **all communications** between investment firms, potential clients and clients, and requires that all information must be 'fair, clear and not misleading'. Article 24(3) applies to mandated and non-mandated disclosures. An exception to this obligation is provided by Recital 73 of the

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53 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, paras 42, 47, Annex 3.3 para 34.

54 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, para 52.

55 ESMA, Final report: Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620, para 55.

MiFID II Delegated Regulation, and applies when an investment firm provides to a client a copy of a prospectus that has been drawn up and published in accordance with Directive 2003/71/EC, if the firm is not responsible under Directive 2003/71/EC for the information given in the prospectus.. The exception exists because requirements under Art 24(3) should not overlap with requirements for preparing prospectuses under Directive 2003/71/EC.[56] Information must be connected to the provision of investment services or ancillary services in order to fall within the scope of Art 24(3), as evidenced by the reference to 'clients' in the provision. Information is considered to be **misleading** if it has a tendency to mislead the person or persons to whom it is addressed or by whom it is likely to be received, regardless of whether the person who provides the information considers or intends it to be misleading.[57] Article 24(3) clarifies that **marketing communications** are information for the purposes of MiFID II. Marketing Communications must be clearly identifiable as such (under the second sentence of Art 24(3)). MiFID II regulates marketing communications because retail investors often base their investment decision on marketing material, and because mandatory disclosure of information may be insufficient to counteract the initial influence of marketing communications on the decision-making process.[58] Article 36 of the MiFID II Delegated Regulation distinguishes between investment research[59] and recommendations of the type covered by point (35) of Art 3(1) of Regulation 596/2014. Investment research is a sub-category of these recommendations.[60] If these recommendations do not meet the conditions set out in Art 36(1) of the

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56 CESR, Technical Advice on Level 2 Implementing Measures on the first set of mandates: MiFID feedback statement, January 2005, CESR/05-025, 31.

57 Recital 68 MiFID II Delegated Regulation.

58 CESR, Technical Advice on Level 2 Implementing Measures on the first set of mandates, Markets in Financial Instruments Directive, Feedback Statement, CESR/05-025, January 2005, 31; Martin Brenncke, *Regelung der Werbung im Bank- und Kapitalmarktrecht* (Schulthess & Nomos 2013) 552, 870

59 As defined in Art 36(1) of the MiFID II Delegated Regulation. Investment research is an ancillary service (Annex I, Section B(5) MiFID II) and not marketing material.

60 Recital 50 MiFID II Delegated Regulation. For a detailed assessment of the complex demarcation between both categories under the terms of Art 24 MiFID I Implementing Directive see Martin Brenncke, 'Die Abgrenzung von Finanzanalysen und anderen Empfehlungen zur Werbemitteilung: Zur Europarechtswidrigkeit des deutschen Rechts' (2009) 21 Journal of Banking Law and Banking 361.

MiFID II Delegated Regulation, they are treated as marketing communications for the purposes of MiFID II and must be clearly identified as such.[61]

6 Article 44 of the MiFID II Delegated Regulation amplifies Art 24(3), and sets out more detailed requirements regarding the **content and presentation of information** that investment firms address to, or disseminate in such a way that is likely to be received by, potential or actual retail or professional clients. Article 44 of the MiFID II Delegated Regulation is modelled on Art 27 of the MiFID I Implementing Directive and makes targeted improvements to the MiFID I regime. An important innovation of the MiFID II Delegated Regulation is that its scope of application is extended to professional clients. According to Recital 65 of the MiFID II Delegated Regulation, Art 44 of the MiFID II Delegated Regulation does not apply to marketing communications which consist only of one or more of the following: the name of the firm, a logo or other image associated with the firm, a contact point, and a reference to the types of investment services provided by the firm. Yet, based on the wording and the purpose of Art 24(3) of MiFID II and Art 44 of the MiFID II Delegated Regulation, marketing communications of the type mentioned in Recital 65 of the MiFID II Delegated Regulation should be covered by the scope of those provisions.[62] Article 44 of the MiFID II Delegated Regulation provides detailed requirements for information provided to clients or potential clients to be considered fair, clear and not misleading.[63] The detailed requirements are **exhaustive**[64]. In contrast to other provisions of the MiFID II Delegated Regulation, the wording of Art 44(1) does not include the words ‘in particular’ or ‘at least’. Additionally, the high level of detail used in Art 44 speaks in favour of interpreting the provision to be exhaustive. Article 44(1), when read in conjunction with its heading, implies that investment firms that provide information which satisfies the

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61 Art 36(2) of the MiFID II Delegated Regulation.

62 Martin Brenncke, *Regelung der Werbung im Bank- und Kapitalmarktrecht* (Schulthess & Nomos 2013) 846-851.

63 Examples of bad practices in the context of information relating to contracts for difference that would not meet this standard are provided in ESMA, Q & A relating to the provision of CFDs and other speculative products to retail investors under MiFID, 31 March 2017, ESMA/35-36-794, section 3, Question 1 para 2, Question 2 para 20.

64 For a different view: Jonathan Herbst, *A practitioner’s guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 200.

conditions laid down in Arts 44(2) through (8) of the MiFID II Delegated Regulation are considered to have provided information that is fair, clear and not misleading and, thus, fulfil the requirements of Art 24(3). The conditions laid down in Arts 44(2) through (8) of the MiFID II Delegated Regulation must be interpreted consistently with the high-level principles in Art 24(3).

7 Article 44 of the MiFID II Delegated Regulation stops short of requiring pre-approval of marketing communications or of prescribing the content. Information provided in materials must be up-to-date, accurate and must always give a **fair and prominent indication of any relevant risks** when referencing any potential benefits of an investment service or financial instrument. The term 'risks' is interpreted broadly in accordance with Recital 67 of the MiFID II Delegated Regulation and includes drawbacks and weaknesses.[65] Article 44 also contains requirements as to the font size and the layout of information about risks. Information must be sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received. This obligation recognises that the standard of comprehensibility is adaptable to different subgroups of clients within the wider category of retail and professional clients. What this obligation does not clarify is what information must be sufficient for.[66] Furthermore, information must not disguise, diminish or obscure important items, statements or warnings. Information must also be consistently presented in the same language, unless the client has agreed to receive information in more than one language. However, firms are not required to translate prospectuses provided to clients.[67]

8 Further detailed requirements in Art 44 of the MiFID II Delegated Regulation apply to information containing (a) comparisons between instruments or services, (b) an indication of **past performance** of a financial instrument, a financial index or an investment service, (c) information on simulated past performance, (d) information on future performance, (e) a reference to a particular tax treatment, and (f) the name of any competent authority.

65 Recital 67 MiFID II Delegated Regulation.

66 For discussion in relation to marketing communications see Martin Brenncke, *Regelung der Werbung im Bank- und Kapitalmarktrecht* (Schulthess & Nomos 2013) 732-737.

67 Recital 66 MiFID II Delegated Regulation.

Article 46(6) of the MiFID II Delegated Regulation specifies requirements for direct-offer marketing communications. Article 46(5) of the MiFID II Delegated Regulation requires investment firms to ensure that information contained in a marketing communications is consistent with other information the firm provides to clients.

2. Mandated disclosure

a) General requirements

9 Article 24(4) contains MiFID II's overarching disclosure requirement. It specifies what information investment firms must provide to potential clients and clients with regard to (a) the relevant investment firm and its services, (b) the financial instruments and proposed investment strategies, (c) execution venues and (d) all costs and related charges. MiFID II retains MiFID I's existing disclosure requirements but also includes more detailed requirements and expands their scope. In particular, under Art 24(4)(b), information on financial instruments must now indicate whether an instrument is intended for retail or professional clients, taking into account the target market identified in accordance with the new product-governance requirements. Furthermore, paragraph 2 of Art 24(4)(c) of MiFID II introduces **additional disclosure requirements** regarding information about costs and charges of a financial instrument or financial service. All costs and charges which are not caused by the occurrence of 'underlying market risk' must be aggregated to allow a client to understand the overall cost as well as the cumulative effect on return of the investment. Underlying market risk in Art 24(4)(c) means movements in the value of capital invested caused directly by movements in the value of the underlying assets.[68] MiFID II considers **disclosure of costs**, together with disclosure of risks, as key elements which enhance the ability of investors to assess the products that are offered to them. The disclosure of costs and charges is underpinned by the principle that every difference between the price of a position for the firm and the respective price for the client should be disclosed, including mark-ups and mark-downs.[69]

68 Recital 79 MiFID II Delegated Regulation.

69 Recital 79 MiFID II Delegated Regulation.

10 Under Arts 24(4) and (5), information must be appropriate, provided in good time and provided in a comprehensible form in order to ensure that clients and potential clients are reasonably able to understand the nature and risks of the relevant investment service and of the specific type of financial instrument that is being offered, and, consequently, can make investment decisions on an informed basis. MiFID II aims to **empower investors** to make educated investment decisions based on full disclosure. Member States may allow information to be provided in a **standardised format** under the second sentence of Art 24(5). According to ESMA, 'standardised' does not mean that a disclosure has to be individualised or generic, but refers to the formal appearance, content and layout.[70] The requirement to provide information in good time has to be considered in light of a client's relevant prior experience, familiarity with the product, the complexity of the product, and must take into account a client's need for sufficient time to read and understand the information provided before making an investment decision (see Recital 83 of MiFID II).

11 Recital 84 of MiFID II clarifies that as long as information is communicated to the client in good time, an investment firm is neither required to provide all required information to the client at the same time, nor required to incorporate the information into an agreement. The rules do not take into account the possibility of **information overload** negatively affecting the client's understanding of the disclosed information. It follows that the issue of information overload is neglected with respect to interpreting the requirement that information be provided in a comprehensible form. If sufficient information in relation to the costs, associated charges, and risks of a financial instrument, is provided in accordance with other Union law (e.g. the UCITS KIID or PRIIPS KID), that information is appropriate for the purpose of Art 24(4); additionally, an investment firm must disclose to a client all other costs and charges relating to the investment service provided in accordance with Recital 78 of MiFID II.

b) MiFID II Delegated Regulation

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70 ESMA, Consultation paper on MiFID II/MiFIR, 22 May 2014, ESMA/2014/549, 111-112.

12 The content and format of information required pursuant to Art 24(4) is supplemented by an extensive **catalogue of disclosures** set out in Arts 45 through 51 of the MiFID II Delegated Regulation (which was based on Arts 28 through 34 of the MiFID I Implementing Directive). Investment firms must inform a client about the firm's categorisation of the client, of any right the client has to request a different categorisation, and about any limitations to the level of client protection that a different categorisation would entail (see Arts 45(1) and (2) of the MiFID II Delegated Regulation). Articles 46(1) and (2) of the MiFID II Delegated Regulation expands when, on an ex-ante basis, investment firms must inform a client or potential client about the terms of an agreement to provide investment or ancillary services, and must provide the information mandated under Arts 47 through 50 of the MiFID II Delegated Regulation. Information can be provided via a durable medium[71] or by means of publication on a website (where it does not constitute a durable medium).[72] A client must be notified in good time of material changes to the information, provided it is relevant to a service that the firm is providing to that client.[73] Article 47 of the MiFID II Delegated Regulation provides a detailed list of disclosures relating to the investment firm and its services, with specific requirements for portfolio managers.

13 Information about **financial instruments** is mandated by Art 48 of the MiFID II Delegated Regulation, which requires that investment firms must provide potential clients and clients with a general description of the nature and risks of financial instruments, taking into account the characterisation of a client as either a retail client, professional client or eligible counterparty.[74] The description must explain the nature of the specific type of instrument concerned, the functioning and performance of the financial instrument in different market conditions, including under both positive and negative conditions, as well as the risks particular to that specific type of instrument in

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[71] See Art 4(1)(62) and Art 3(1) MiFID II Delegated Regulation.

[72] Art 46(3) MiFID II Delegated Regulation.

[73] Art 46(4) MiFID II Delegated Regulation.

[74] See Recital 63 MiFID II Delegated Regulation.

sufficient detail.[75] The **level of detail** necessary may vary according to whether a client is a retail client or a professional client, and the nature and risk profile of the financial instruments that are being offered, but should always include any essential elements.[76] The elements necessary when describing the risks of a specific type of financial instrument are elaborated on in Art 48(2) of the MiFID II Delegated Regulation. Further informational requirements relating to specific financial instruments are imposed where a financial instrument is composed of two or more different financial instruments or services, incorporates a guarantee or capital protection, and with respect to retail clients where a prospectus is available for the financial instrument.[77] Investment firms holding financial instruments or funds belonging to clients must meet the disclosure requirements enshrined in Art 49 of the MiFID II Delegated Regulation.

c) Information about costs and charges

14 Article 50 of the MiFID II Delegated Regulation sets out detailed requirements regarding what information investment firms must provide to clients about costs and charges pursuant to Art 24(4) of MiFID II, for example, (a) what kind of costs must be aggregated for **ex-ante and ex-post disclosures** about costs and charges, (b) that calculations of costs and charges for ex-ante disclosures should be based on actually incurred costs or, if these are not available, on a reasonable estimation,[78] (c) that investment firms must provide clients with an **illustration** showing the cumulative effect of costs on return,[79] and (d) that investment firms that recommend or market services provided by another firm must aggregate the costs and charges of its services together with the costs and charges of the services provided by the firm. Aggregated costs and charges shall be totalled and expressed both as a cash amount and as a

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75 Art 48(1) sentence 2 MiFID II Delegated Regulation.

76 Recital 64 MiFID II Delegated Regulation.

77 Art 48(4), (5), (3) MiFID II Delegated Regulation.

78 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.14 provides details on when an estimation is reasonable.

79 For requirements relating to the illustration see Art 50(10) MiFID II Delegated Regulation and ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.2 and 9.3.

percentage.[80] In addition, investment firms are allowed to provide potential clients and clients with separate figures comprising aggregated initial costs and charges, aggregated on-going costs and charges and aggregated exit costs.[81]

15 Ex-ante information about the costs related to the financial instrument may be provided based on an assumed investment amount, whereas ex-post disclosures should reflect a client's actual investment amount at the time the disclosure is produced.[82] Investment firms that recommend or market[83] financial instruments to clients or are required to provide a client with a UCITS KIID or PRIIPs KID must provide a **full ex-ante disclosure** of information about the aggregated costs and charges related to the financial instrument and to the investment or ancillary service provided.[84] According to ESMA, an investment firm can fulfil its obligation under MiFID II with regard to ex-ante disclosure of costs and charges of a PRIIP by relying on the cost information presented in the PRIIPs KID, since the cost components mentioned in the PRIIPs KID cover all cost components.[85] Investment firms referred to above must also provide **annual post-sale information** about all costs and charges related to both the financial instruments sold and the services provided, provided that a client and firm have had an ongoing client relationship during the given year.[86] Such information must be based on costs incurred, must be provided on a personalised basis and can be provided together with any existing periodic reporting to clients.[87] The annual post-sale information must be provided once a year, but may be provided more frequently, for example, each time a client

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80 Art 50(2) subpara 2 MiFID II Delegated Regulation. In detail: ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.13.

81 Recital 80 MiFID II Delegated Regulation.

82 Recital 78 MiFID II Delegated Regulation.

83 For the meaning of "recommend or market" see ESMA, Consultation paper on MiFID II/MiFIR, 22 May 2014, ESMA/2014/549, 102-103.

84 Art 50(5) MiFID II Delegated Regulation.

85 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.7.

86 Art 50(9) subpara 1 sentence 1 MiFID II Delegated Regulation.

87 Art 50(9) subpara 1 sentence 2, subpara 2 MiFID II Delegated Regulation. See ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.1 for guidance on how to calculate the total costs incurred if the client buys and sells a fund during the business year.

receives a report about their investments.[88] Investment firms not referred to above, for example, firms that passively execute orders, need only to inform their clients about all costs and charges relating to the service (and not the underlying financial instrument) which the firm provides.[89] Article 51 of the MiFID II Delegated Regulation clarifies that investment firms distributing UCITS or PRIIPs must inform their clients about any other costs and associated charges related to the product which are not included in the relevant KIDs, and about any costs and charges of an investment service related to a financial instrument.

16 Investment firms may agree with **professional clients and eligible counterparties** to limit the application of the requirements set forth in Arts 50(2)-(10) of the MiFID II Delegated Regulation, unless certain conditions are met.[90] The MiFID II Delegated Regulation does not specify the extent to which the requirements may be limited, but it is clear that the parties cannot agree on standards below those set out in Art 24(4) of MiFID II.

d) Disclosure requirements for certain investment services

17 Special disclosure requirements arise (a) when an investment firm provides advice on corporate finance strategy and provides the service of underwriting or placing of financial instruments (Art 38(1) of the MiFID II Delegated Regulation),[91] (b) in relation to pricing of offerings in relation to issuance of financial instruments (Art 39(2) of the MiFID II Delegated Regulation), (c) for investment firms placing financial instruments (Art 40 MiFID of the II Delegated Regulation), and (d) for investment firms engaged in offering financial instruments which the investment firm itself, or another entity in its group, would issue to their clients, when those instruments are included in the firm's calculation of prudential requirements (Art 41(4) of the MiFID II Delegated Regulation).

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88 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 9.4-9.5.

89 Art 50(6) MiFID II Delegated Regulation.

90 Art 50(1) subparas 1, 2 MiFID II Delegated Regulation.

91 For further guidance on the interpretation of Art 38(1) see ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 6.1-6.4.

3. Investment advice

18 Article 24(4)(a) of MiFID II also contains specific requirements to disclose information when investment advice is provided. **Disclosure requirements** newly introduced by MiFID II for advisers require advisers to inform a potential client or client in good time, before providing investment advice, and in sufficient detail,[92] (a) whether or not advice is provided on an independent basis, (b) whether the advice is based on a broad or on a more restricted analysis of different types of financial instruments, and in particular, whether the range of financial instruments is limited to those issued by entities closely linked to or tied to the firm, and (c) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client.

19 Article 52 of the MiFID II Delegated Regulation specifies the particular disclosures required pursuant to Art 24(4)(a). Firms shall properly explain to potential clients and clients the scope and the features of any advice given. For example, investment firms shall provide a description of the types of financial instruments considered and the range of financial instruments and providers analysed per each type of instrument in accordance with the scope of the service. Sufficient details about the number of financial instruments analysed by the firm should be provided to its clients.[93] Irrespective of the scope of the service offered, all assessments should be based on an **adequate number of financial instruments** which are available in the market to allow an appropriate consideration of alternatives.[94] Investment firms must also describe the factors considered in the selection process when recommending financial instruments.[95]

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92 Recital 70 MiFID II Delegated Regulation.

93 Recital 70 MiFID II Delegated Regulation.

94 Ibid.

95 Art 52(3) MiFID II Delegated Regulation.

V. Derogation from the scheme created by Art 24 (Art 24(6)

20 Article 24(6) provides a derogation from the obligations set out in Art 24. Article 24(6) must be **interpreted strictly** to mean,[96] first, that an investment service is offered as 'part of a financial product' only when it forms an integral part thereof at the time when the relevant financial product is offered to the client and, second, that the provisions of Union law referred to by Art 24(6) must include provisions setting out disclosure requirements that apply to the investment service which forms an integral part of the financial product in question. Under Art 24(6), the above conditions must both be met in order for an investment service to be exempted from the obligations laid down in Arts 24(3)-(5) of MiFID II.[97] The second condition discussed above does not require that disclosures be identical to disclosures required under Arts 24(3)-(5).[98] Indications that an investment service does not form an integral part of the financial product in question include that the duration of the financial instrument to which that service relates is greater than that of the product, that a single financial instrument applies to different financial products offered to the same client or that the instrument and the product are offered in different contracts.[99] Whereas Art 19(9) of MiFID I referred to EU law relating to credit institutions and consumer credits with respect to risk assessment of clients and/or information requirements, Art 24(6) has limited the scope of the derogation to information requirements. Thus, Art 24(6) does not exempt a suitability assessment (discussed further under Art 25 below) in accordance with MiFID II.

VI. Independent investment advice (Art 24(7))

21 MiFID II reforms the structure of the investment advice industry by introducing the concept of providing investment advice on an independent basis. This **reform of the investment advice market** was introduced due to concerns over the quality of advice and mis-selling problems which were not prevented by

96 Case C-604/11 *Genil v Bankinter* ECLI:EU:C:2013:344 paras 39, 48.

97 Case C-604/11 *Genil v Bankinter* ECLI:EU:C:2013:344 paras 39, 48.

98 Ibid, paras 45, 47.

99 Ibid, para 44.

MiFID I.[100] Whether or not the fee-based independent adviser model will become a success will depend on (a) whether it can overcome the considerable reluctance of retail investors to pay a fee for investment advice, and (b) the (alleged)[101] unwillingness of advisers to advise those with limited assets. MiFID II's reform of the advice industry has also been criticised for not sufficiently addressing conflicts of interest arising from advising about and selling proprietary products.[102]

22 In order for investment advice to be considered independent, two conditions must be fulfilled according to Art 24(7). First, an independent adviser must assess a **sufficient range of financial instruments** available on the market which must be sufficiently diverse with regard to type of instrument, issuer or product provider, and may not be limited to proprietary or otherwise tied financial instruments (see Art 24(7)(a)). The standard requires less than assessing the full range of financial instruments available.[103] The criteria further governing the assessment necessary under Art 24(7)(a) are provided by Art 53 of the MiFID II Delegated Regulation. An independent investment adviser must not be bound by any form of agreement with a product provider that may limit the adviser's ability, or the ability of a firm employing the adviser, to provide unbiased advice. Article 53(2) of the MiFID II Delegated Regulation also clarifies that independent investment advice can be provided by firms that focus on certain categories or a specified range of financial instruments, subject to restrictions provided in that article.

23 Second, Art 24(7)(b) stipulates a **prohibition on inducements** ('fees, commissions or any monetary or non-monetary benefits paid or provided by any third party') being received by independent advisers. The prohibition is designed to reduce the risk of conflicts of interest. The prohibition creates the

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100 Commission, Impact Assessment accompanying the MiFID II/MiFIR proposals, 20 October 2011, SEC(2011) 1226 final, 16. For concerns about the quality of advice under the MiFID I regime see Synovate, Consumer Market Study on Advice within the Area of Retail Investment Services—Final Report, 2011, 6-13.

101 For the UK see Financial Conduct Authority, Financial Advice Market Review: Final Report, March 2016, 6.

102 Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 805.

103 Recital 73 MiFID II.

condition that makes independent investment advice a fee-based service. If an independent adviser receives inducements, the value of the inducement must be transferred in full to the affected client or clients as soon as reasonably possible after receipt, and any affected client must be informed about it, for example through the periodic reporting statements provided to a client.[104] A corresponding policy should be set up as part of a firm's organisational requirements.[105] Recital 74 of MiFID II also clarifies that a firm is not allowed to offset any third-party payments from the fees due from a client to the firm.

24 A ***de minimis* exception** applies to minor non-monetary benefits (see the second sentence of Art 24(7)(b)). Minor non-monetary benefits are excluded from the prohibition if they are (a) capable of enhancing the quality of service provided to a client (enhancement requirement), (b) of a scale and nature such that they could not be judged to impair compliance with the firm's duty to act in the best interest of the client and (c) clearly disclosed to the client. Article 12(3) of the MiFID II Delegated Directive lists the minor non-monetary benefits that are deemed acceptable under MiFID II.[106] Despite that the list appears to limit the definition of minor non-monetary benefits, it allows Member States to recognise other minor non-monetary benefits as acceptable provided that certain circumstances are met.[107] Without prejudice to this possibility, benefits which meet the '**enhancement requirement**' in Art 24(7)(b) are exhaustively listed in Art 12(3) of the MiFID II Delegated Directive. Acceptable minor non-monetary benefits must, furthermore, be reasonable and proportionate and of such a scale that they are unlikely to influence the investment firm's behaviour in any way that is detrimental to the interests of the relevant client.[108] Any non-monetary benefit that involves a third party allocating valuable resources to an investment firm cannot be considered as minor.[109] Acceptable minor non-monetary benefits must be disclosed to the relevant client or clients prior to providing advice; any minor non-monetary benefits may be described in a

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104 Art 12(1) subparas 1 and 3 MiFID II Delegated Directive; Recital 74 MiFID II.

105 Art 12(1) subpara 2 MiFID II Delegated Directive; Recital 74 MiFID II.

106 Art 12(2) MiFID II Delegated Directive.

107 Art 12(3)(e) MiFID II Delegated Directive.

108 Art 12(3) subpara 2 MiFID II Delegated Directive.

109 Recital 30 MiFID II Delegated Directive.

generic way (summary description of the benefit without any assessment of their value).[110]

25 Article 53(1) of the MiFID II Delegated Regulation provides that independent investment advisers must create and implement a selection process to assess and compare a range of sufficiently diverse financial instruments, which must contain the elements provided for in Arts 53(3)(a)-(d) of the MiFID II Delegated Regulation. These elements do not require advisers to consider a specific, or even a minimum, number or variety of financial instruments. Rather, the **number and variety of financial instruments** which must be assessed and compared must be proportionate to the scope of the advisory services offered, adequately representative of financial instruments available on the market, proportionate to the quantity of financial instruments issued by the investment firm itself or by entities closely linked to the investment firm, and proportionate to the characteristics of the investment firm's clients. For firms providing both independent and non-independent advice, Art 53(3) of the MiFID II Delegated Regulation imposes additional restrictions, namely (a) disclosing the correct advisory service to clients, (b) restrictions on presenting the firm as independent and (c) having organisational controls to ensure that independent and non-independent advice and advisers are clearly separate (including that the same adviser does not provide both types of advice).

26 The requirements for independent investment advice and advisers do not rule out the possibility that unbiased and unrestricted analysis of financial instruments could result in a firm recommending financial instruments which are issued or provided by the firm itself or by entities having close links. If independent advice offered by a firm routinely or frequently results in recommendations of proprietary or otherwise tied financial instruments, ESMA expects that firm to thoroughly assess whether the recommendations are the result of any conflict of interest.[111]

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110 Art 12(3) subpara 3 MiFID II Delegated Directive.

111 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 5.1.

VII. Inducements (Arts 24(8)-(9))

27 Commission-based distribution has been associated with a **range of failures**, including giving poor quality advice and mis-selling. The strengthened regime for inducements under MiFID II is designed to enhance the quality of advice and to reduce the vulnerability of clients arising from risks of conflicts of interest. Despite discussing proposals to prohibit all third-party payments or benefits across all distribution channels, the Member States, reflecting local industry structures, could not agree on a prohibition more stringent than that suggested by the Commission in its 2010 MiFID I review for independent investment advice and for portfolio management.[112] Member States are, however, free to impose a general ban on inducements for all distribution channels if the requirements of Art 24(12) are fulfilled. As a general requirement, all investment firms (including independent investment advisers) must have in place **policies and systems** to assess the nature of any service, benefit or material provided by or to any third party to determine whether the investment firm may accept it or provide it, as the case may be, under the applicable inducement rules.[113]

1. Portfolio management services

28 Article 24(8) prohibits portfolio managers from receiving inducements, which mirrors Art 27(b) with regard to independent investment advisers (see above paragraphs 23-24 for discussion).

2. All other investment services

29 For all other investment firms other than portfolio managers and independent investment advisers, Art 24(9) states the general rule that an investment firm does not act in the best interest of its clients when it receives or provides inducements in connection with providing an investment service or an ancillary service. An exception applies, and the relevant inducement does not have to be passed on to clients, if the inducement is (a) designed to enhance the quality of a client service, (b) consistent with the firm's duty to act in a client's best

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112 Cyprus Presidency Progress Report on MiFID II/MiFIR, 13 December 2012, Council Document 16523/128, 8.

113 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.3.

interest, and (c) clearly disclosed to the affected client (see Art 24(9)). Particular requirements regarding inducements also apply to specific investment services offered: (a) when an investment firm places financial instruments under Art 40(3) of the MiFID II Delegated Regulation, and (b) when an investment firm provides services to a client to participate in a new issue under Art 41(1) of the MiFID II Delegated Regulation.

30 Article 11(2) of the MiFID II Delegated Directive clarifies that a fee, commission or non-monetary benefit is designed to enhance the quality of the relevant service to the client if the conditions specified in Art 11(2)(a)-(c) of the MiFID II Delegated Directive are satisfied. The conditions for a fee, commission or non-monetary benefit to be considered **quality enhancing** will be construed strictly.[114] Investment firms must be able to show evidence that the conditions have been met, and must meet the conditions on an ongoing basis so long as an investment firm continues to pay or receive the relevant inducements.[115] For example, an inducement must be justified by the provision of an additional or higher level service to the affected client, proportional to the level of inducements received, and Art 11(2)(a) provides a non-exhaustive list of examples when this would be the case. Non-independent investment advisers may fulfil this condition, for example, if they provide clients with access to a wide range of suitable financial instruments including an appropriate number of instruments offered by third parties having no close links with the investment firm. Even though the wording of Art 11(2)(c) of the MiFID II Delegated Directive appears to rule out **one-off inducements**, as opposed to on-going inducements, this seems to be a 'drafting' error in the uptake of ESMA's technical advice.[116] One-off inducements should thus be capable of meeting the quality enhancement criterion if they fulfil the other two conditions set out in the Art 11(2)(b) and (c) of the MiFID Delegated Directive.

31 Paragraph 2 of Art 24(9) requires investment firms to, where applicable, inform clients of how an inducement can be transferred to him or her. Firms need to

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114 Commission, Request to ESMA for technical advice on possible delegated acts concerning MiFID II, 23 April 2014, 26.

115 Art 11(3), (4) MiFID II Delegated Directive.

116 ESMA, Final report: ESMA's technical advice to the Commission on MiFID II and MiFIR, 19 December 2014, ESMA/2014/1569, 142.

clearly disclose to a client, in a manner that is comprehensive, accurate and understandable, prior to the provision of an investment service, the existence, nature and amount of any relevant inducement, or, where the amount cannot be ascertained, the method of calculating that amount. This **disclosure requirement** is supplemented by Art 11(5) of the MiFID II Delegated Directive, which addresses key issues raised by the Commission in its review of MiFID I's regime governing inducements[117] relating to difficulties in distinguishing between summary and detailed disclosures, the absence of ex-post disclosures and the absence of any details regarding the content of the disclosure.

32 Paragraph 3 of Art 24(9) of MiFID II includes a non-exhaustive list of payments and benefits which are excepted from the general prohibition against inducements, such as custody costs, settlement and exchange fees, regulatory levies or legal fees. These payments or benefits must enable or be necessary for the provision of investment services and they must not, by their nature, give rise to conflicts with the investment firm's general obligation of fair treatment.

3. Research conducted by third parties

33 Investment firms, including financial advisers and portfolio managers, use research when making decisions regarding investment advice or portfolio management. Receiving research conducted by third parties is generally considered an **inducement** under MiFID II.[118] A broad definition of research is provided by Recital 28 of MiFID II Delegated Directive, according to which two conditions need to be met: (1) A material or service must concern one or several financial instruments or other assets, or current or potential issuers of financial instruments, or be closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that industry or market. (2) This material or service explicitly or implicitly recommends or suggests an investment strategy and provides a substantiated opinion as to the present or future value or price of such instruments or assets, or otherwise contains analysis and original insights and reaches conclusions based on new or existing information that could be used to inform an investment strategy and

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117 Commission, Public consultation: review of MiFID, 8 December 2010, 60.

118 Art 13 MiFID II Delegated Directive is drafted as an exception.

is relevant and capable of adding value to an investment firm's decisions which it makes on behalf of clients being charged for that research.[119] Any assessment of whether material is substantive or not is dependent on its content and not any label given by the provider.[120] The following material is not considered research provided by third parties for the purposes of Art 13 MiFID II Delegated Directive: **Non-substantive material** or services consisting of short term market commentary on the latest economic statistics or company results or information on upcoming releases or events, which is provided by a third party and contains only a brief summary of its own opinion on such information that is not substantiated nor includes any substantive analysis, for example, material that reiterates a view based on an existing recommendation or substantive research material or services. Material described above, if provided to an investment firm by a third party, could be deemed to be information relating to a financial instrument or an investment service that is generic in nature pursuant to Art 12(3)(a) of the MiFID II Delegated Directive and would constitute an acceptable minor non-monetary benefit.[121] The same applies to material repeating or summarising public news stories or public statements from corporate issuers.[122] Macro-economic analysis may be classified as research it if falls under the definition of research set out in Recital 28 of MiFID II Delegated Directive. If macro-economic analysis is not considered research in an individual case, it does not automatically classify as a minor non-monetary benefit.[123]

34 The dominant market practice prior to the enactment of MiFID II was for brokers to bundle payments for research into transaction costs, a practice that is not permissible under MiFID II. Research is not regarded as an inducement, and therefore is permissible, if it is received in return for (a) **direct payments** by the

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119 This broad definition of research includes investment research as defined in Art 36(1) MiFID II Delegated Regulation.

120 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.6.

121 Recital 29 MiFID II Delegated Directive.

122 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.6.

123 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.8.

investment firm from its own resources or (b) payments from a separately created research payment account which the investment firm controls (see Art 13(1) of the MiFID II Delegated Directive for more information). An investment firm may reflect research costs made by direct payments out of its own resources by increasing its portfolio management or advisory fees.[124] Among the obligations for operating a **research payment account** are obligations to fund it through a specific research charge to the client, to set and regularly assess a research budget and to regularly assess the quality of the research purchased provided. According to ESMA, a research budget can be set for a group of client portfolios or accounts which share sufficiently similar investment objectives and research needs.[125] Even where a research budget is used to serve several portfolios, a firm is still required to provide individual clients with a specific research charge amount. The specific research charge must not be linked to the volume and/or value of transactions executed on behalf of clients.[126]

35 Consistent with Art 24(4)(c) of MiFID II, a range of ex-ante and ex-post **disclosures** about research payment accounts must be made to clients,[127] and the total amount of any research fee charged to clients must not exceed the research budget.[128] Article 13(9) of the MiFID II Delegated Directive also specifies that any payment for third-party research should not be linked to payments made for executing orders. If a firm provides execution services and also provides unsolicited (or 'free') research, the firm would not meet its obligation under Art 13(9) of the MiFID II Delegated Directive to price services separately.[129]

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124 ESMA, Final report: technical advice to the Commission on MiFID II and MiFIR, 19 December 2014, ESMA/2014/1569, 138.

125 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.1.

126 Art 13(2)(b) MiFID II Delegated Directive.

127 Art 13(1)(c), (2), (8) MiFID II Delegated Directive. See also ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.10-7.11.

128 Art 13(4) MiFID II Delegated Directive.

129 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.3.

36 The MiFID II Delegated Directive does not expressly state whether or not its Art 13 is exhaustive with respect to what could constitute inducements in relation to research. Written material received by an investment firm from a third party that is commissioned and paid for by a corporate issuer, or potential issuer, to promote a new issuance by that company, may be considered acceptable minor non-monetary benefits pursuant to Art 12(3)(b) of the MiFID II Delegated Directive, provided that the provision's further conditions are fulfilled. Such material is not considered 'research' for the purposes of Art 13 of the MiFID II Delegated Directive.[130]

37 At first it appears unclear whether material that fulfils the definition of research conducted by third parties could ever constitute an acceptable minor non-monetary benefit by fulfilling the conditions of Art 12(3)(a) MiFID II Delegated Directive when provided to an independent investment advisor or a portfolio manager. It also appears unclear whether research provided by a third party to an investment firm can ever fulfil the quality enhancement criterion under Arts 24(9)(a) of MiFID II, 11(2) of the MiFID II Delegated Directive. The recitals in the MiFID II Delegated Directive suggest that the answer to the first ambiguity is no.[131] ESMA agrees that independent investment advisers and portfolio managers may only receive research by complying with Art 13 of the MiFID II Delegated Directive. It follows that independent investment advisors and portfolio managers may not accept **research for free**.[132] In relation to all other investment firms, ESMA's position is that a firm receiving research can assess whether the receipt of the research meets the quality enhancement criterion. If it does, the firm can receive the research for free. If the firm pays for the research, it must comply with Art 13 of the MiFID II Delegated Directive.[133]

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130 Recital 29 MiFID II Delegated Directive ("other types of information or material received from third parties").

131 Ibid.

132 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 7.3 (also with regard to how to deal with unsolicited research), 7.6.

133 For further details see ibid; cf Recital 54 MiFID II Delegated Regulation ("only").

VIII. Staff remuneration (Art 24(10))

1 Conflict of interest risk resulting from remuneration arrangements threatens good outcomes for investors and contributes considerably to mis-selling and poor-quality investment advice.[134] Remuneration structures have significant potential to misalign incentives in the distribution process, which is why an investment firm must ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interest of its clients (see the first sentence of Art 24(10)). In particular, remuneration structures and sales targets should not incentivise staff to recommend inappropriate financial instruments to retail clients (see the second sentence of Art 24(10)). The rules of conduct in Art 24(10) are supplemented by MiFID II's firm-governance regime, which requires that a management body define, approve and oversee any remuneration policy of persons involved in the provision of services to clients under Art 9(3)(c). **Remuneration** refers to all forms of payments or financial or non-financial benefits provided directly or indirectly by firms to relevant persons that provide investment or ancillary services to clients (remuneration is defined by Art 2(5) of the MiFID II Delegated Regulation). This broad definition includes cash, shares, options, cancellations of loans to relevant persons at dismissal, pension contributions, wage increases, promotions, health insurance, discounts or special benefits such as generous expense accounts or seminars in exotic destinations, and remuneration by third parties through, for example, carried interest models.[135]

2 Article 27 of the MiFID II Delegated Regulation specifies how **remuneration policies and practices** need to be designed and implemented by an investment firm, and it broadly defines the relevant persons governed by the provision. The relevant persons include front-office staff, sales force staff, tied agents, persons involved in complaints-handling, persons involved in product design and development, persons overseeing sales forces (such as line managers) who may be incentivised to pressure sales staff, financial analysts whose literature may be used by sales staff to entice clients to make investment

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134 Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 793-794.

135 Recital 40 of the MiFID II Delegated Regulation.

decisions and other staff indirectly involved in the provision of investment services.[136] In particular, a balance between fixed and variable components of remuneration shall be maintained at all times. Remuneration and similar incentives shall not be solely or predominantly based on quantitative commercial criteria (like sales volumes or value of instruments sold) but shall take into account qualitative criteria reflecting compliance with the applicable regulations, fair treatment of clients and the quality of client service.[137] Article 27 of the MiFID II Delegated Regulation is informed by ESMA's guidelines relating to remuneration policies and practices under MiFID I; ESMA's guidelines may also be taken into account when determining what is considered **good practice** under the MiFID II standard.[138]

IX. Cross-selling practices (Art 24(11))

3 The practice of bundling or tying together investment services or other services or products can distort competition and negatively affect client mobility and the ability of clients to make informed choices (as stated in Recital 81 of MiFID II). In order to prevent these risks, Art 24(11) contains certain disclosure requirements that an investment firm must fulfil when offering bundled or tied packages.[139] The wording of Art 24(11), 'whether it is possible', indicates that it may not be possible to buy at least one of the different components separately and, thus, does not rule out all tying practices (cf. Recital 81 of MiFID II). ESMA has developed guidelines on cross-selling practices.[140]

X. Gold-plating (Art 24(12))

4 Member States may impose **additional requirements** on investment firms in respect of the matters covered by Art 24 if they meet the strict requirements of Art 24(12). Any additional requirements must not restrict or otherwise affect the passporting rights of investment firms under Arts 34 and 35 of MiFID II. The

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136 Recital 41 MiFID II Delegated Regulation.

137 Art 27(4) of the MiFID II Delegated Regulation.

138 ESMA, Guidelines: remuneration policies and practices (MiFID), 1 October 2013, ESMA/2013/606; ESMA, Final report: technical advice to the Commission on MiFID II and MiFIR, 19 December 2014, ESMA/2014/1569, pp 97-98.

139 Art 4(1)(42) contains the definition for "cross-selling practice".

140 ESMA, Guidelines on cross-selling practices, 11 July 2016, ESMA/2016/574.

MiFID I Implementing Directive contained a similar provision in its Art 4. Under MiFID I, it was controversial whether Member States could depart from not only the implementing measures under the Directive, but also the conduct rules contained in MiFID I. The shift of the provision from an implementing to the framework measure under MiFID II has solved this controversy. Yet, the changes have created a new controversy since the wording of Art 24(12) allows Member States to impose additional requirements in respect of the matters ‘covered by this Article’. It is unclear whether that means that Member States cannot adopt additional requirements in respect of those set out in other Articles relating to operating conditions in Chapter II that do not contain a gold-plating provision. The effect of such a narrow interpretation would render the scope of Art 24(12) significantly narrower than that of its predecessor in Art 4 of the MiFID I Implementing Directive, and would undermine the shift of the provision to the framework directive. Furthermore, specific rules for conducting business within the body of MiFID II specify the duty to act in accordance with a client’s best interest, as enshrined in Art 24(1). Thus, Art 24(12) regulates gold-plating with regard to **all conduct-of-business rules** (contained in Arts 24 through 28).[141]

Article 25 – Assessment of suitability and appropriateness and reporting to clients

1. Member States shall require investment firms to ensure and demonstrate to competent authorities on request that natural persons giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the investment firm possess the necessary knowledge and competence to fulfil their obligations under Article 24 and this Article. Member States shall publish the criteria to be used for assessing such knowledge and competence.

2. When providing investment advice or portfolio management the investment firm shall 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 his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses.

141 Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 340.

Member States shall ensure that where an investment firm provides investment advice recommending a package of services or products bundled pursuant to Article 24(11), the overall bundled package is suitable.

3. Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 2, ask the client or potential client to provide information regarding that person’s knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client. Where a bundle of services or products is envisaged pursuant to Article 24(11), the assessment shall consider whether the overall bundled package is appropriate.

Where the investment firm considers, on the basis of the information received under the first subparagraph, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client. That warning may be provided in a standardised format.

Where clients or potential clients do not provide the information referred to under the first subparagraph, or where they provide insufficient information regarding their knowledge and experience, the investment firm shall warn them that the investment firm is not in a position to determine whether the service or product envisaged is appropriate for them. That warning may be provided in a standardised format.

4. Member States shall allow investment firms when providing investment services that only consist of execution or reception and transmission of client orders with or without ancillary services, excluding the granting of credits or loans as specified in Section B.1 of Annex I that do not comprise of existing credit limits of loans, current accounts and overdraft facilities of clients, to provide those investment services to their clients without the need to obtain the information or make the determination provided for in paragraph 3 where all the following conditions are met:

(a) the services relate to any of the following financial instruments:

(i) shares admitted to trading on a regulated market or on an equivalent third-country market or on a 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 securitised 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 583/2010;

(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 for the purpose of this paragraph.

For the purpose of this point, a third-country market shall be considered to be equivalent to a regulated market if the requirements and the procedure laid down under the third and the fourth subparagraphs are fulfilled.

At the request of the competent authority of a Member State, the Commission shall adopt equivalence decisions in accordance with the examination procedure referred to in Article 89a(2), stating whether the legal and supervisory framework of a third country ensures that a regulated market authorised in that third country complies with legally binding requirements which are, for the purpose of the application of this point, equivalent to the requirements resulting from Regulation (EU) No 596/2014, from Title III of this Directive, from Title II of Regulation (EU) No 600/2014 and from Directive 2004/109/EC, and which are subject to effective supervision and enforcement in that third country. The competent authority shall indicate why it considers that the legal and supervisory framework of the third country concerned is to be considered equivalent and shall provide relevant information to that end.

Such third-country legal and supervisory framework may be considered equivalent where that framework fulfils at least the following conditions:

(i) the markets are subject to authorisation and to effective supervision and enforcement on an ongoing basis;

(ii) the markets have clear and transparent rules regarding the admission of securities to trading so that such securities are capable of being traded in a fair, orderly and efficient manner, and are freely negotiable;

(iii) security issuers are subject to periodic and ongoing information requirements ensuring a high level of investor protection; and

(iv) market transparency and integrity are ensured by the prevention of market abuse in the form of insider dealing and market manipulation.

(b) the service is provided at the initiative of the client or potential client;

(c) the client or potential client has been clearly informed that in the provision of that service the investment firm is not required to assess the appropriateness of the financial instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules. Such a warning may be provided in a standardised format;

(d) the investment firm complies with its obligations under Article 23.

5. The investment firm shall establish a record that includes the document or documents agreed between the investment firm and the client that set out the rights and obligations of the parties, and the other terms on which the investment firm will provide services to the client. The rights and duties of the parties to the contract may be incorporated by reference to other documents or legal texts.

6. The investment firm shall provide the client with adequate reports on the service provided in a durable medium. Those reports shall include periodic communications to clients, taking into account the type and the complexity of financial instruments involved and the nature of the service provided to the client and shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client.

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.

Where the agreement to buy or sell a financial instrument is concluded using a means of distance communication which prevents the prior delivery of the suitability statement, the investment firm may provide the written statement on suitability in a durable medium immediately after the client is bound by any agreement, provided both the following conditions are met:

(a) the client has consented to receiving the suitability statement without undue delay after the conclusion of the transaction; and

(b) the investment firm has given the client the option of delaying the transaction in order to receive the statement on suitability in advance.

Where an investment firm provides portfolio management or has informed the client that it will carry out a periodic assessment of suitability, the periodic report shall contain an updated statement of how the investment meets the client's preferences, objectives and other characteristics of the retail client.

7. If a credit agreement relating to residential immovable property, which is subject to the provisions concerning creditworthiness assessment of consumers laid down in Directive 2014/17/EU of the European Parliament and the Council ([48]), has as a prerequisite the provision to that same consumer of an investment service in relation to mortgage bonds specifically issued to secure the financing of and having identical terms as the credit agreement relating to residential immovable property, in order for the loan to be payable, refinanced or redeemed, that service shall not be subject to the obligations set out in this Article.

8. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to ensure that investment firms comply with the principles set out in paragraphs 2 to 6 of this Article when providing investment or ancillary services to their clients, including information to obtain when assessing the suitability or appropriateness of the services and financial instruments for their clients, criteria to assess non-complex financial instruments for the purposes of point (a)(vi) of paragraph 4 of this Article, the content and the format of records and agreements for the provision of services to clients and of periodic reports to clients on the services provided. Those delegated acts shall take into account:

(a) the nature of the service(s) offered or provided to the client or potential client, having regard to the type, object, size and frequency of the transactions;

(b) the nature of the products being offered or considered, including different types of financial instruments;

(c) the retail or professional nature of the client or potential clients or, in the case of paragraph 6, their classification as eligible counterparties.

9. ESMA shall adopt by 3 January 2016 guidelines specifying criteria for the assessment of knowledge and competence required under paragraph 1.

10. ESMA shall develop by 3 January 2016, and update periodically, guidelines for the assessment of:

(a) financial instruments incorporating a structure which makes it difficult for the client to understand the risk involved in accordance with points (a)(ii) and (a)(iii) of paragraph 4;

(b) structured deposits incorporating a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term, in accordance with point (a)(v) of paragraph 4.

11. ESMA may develop guidelines, and update them periodically, for the assessment of financial instruments being classified as non-complex for the purpose of point (a)(vi) of paragraph 4, taking into account the delegated acts adopted under paragraph 8.

I. General Features

1. Purpose

1 Articles 24 and 25 set out the core conduct-of -business rules with which an investment firm has to comply when providing services to its clients. These rules are supplemented by the MiFID II Delegated Regulation and the MiFID II Delegated Directive. Conduct-of-business rules are one of the mainstays of investor protection as outlined by the Foreword to Art 24 MiFID II.

2. Level 2 and 3 Measures

2 Level 2 measures include the following provisions of the MiFID II Delegated Regulation: Art 54 (assessment of suitability and suitability reports), Art 55 (provisions common to the assessment of suitability or appropriateness), Art 56 (assessment of appropriateness and related record-keeping obligations), Art 57 (provision of services in non-complex instruments), Art 58 (retail and professional client agreements), Art 59 (reporting obligations in respect of execution of orders other than for portfolio management), Art 60 (reporting obligations in respect of portfolio management), Art 61 (reporting obligations in respect of eligible counterparties), Art 62 (additional reporting obligations for portfolio management or contingent liability transactions), Art 63 (statements of client financial instruments or client funds), and Art 73 (record keeping of rights and obligations of the investment firm and the client).

3 Additional level 3 measures include the ESMA, Guidelines for the assessment of knowledge and competence, 22 March 2016, ESMA/2015/1886; and ESMA, Guidelines on complex debt instruments and structured deposits, 4 February 2016, ESMA/2015/1787.

II. Necessary knowledge and competence (Art 25(1))

4 Article 25(1) requires investment firms to demonstrate that their employees are competent to carry out the firm's obligations under MiFID II. The appropriateness and suitability assessments in Arts 25(2) and (3) are context-dependent and process-oriented. This makes enforcement and supervision more difficult and makes the *ex-post* benchmarking of financial advice a complex exercise. MiFID II aims to reduce these difficulties by providing that investment firms must demonstrate to competent authorities, on request, that natural persons giving investment advice or information to clients on behalf of the investment firm possess the necessary knowledge and competence to comply with the MiFID II rules of conduct. Investment firms shall allow their staff sufficient time and resources to achieve that knowledge and level of competence (see Recital 79 of MiFID II). ESMA has created guidelines that specify the criteria to assess knowledge and competence.[142]

III. Suitability (Art 25(2))

5 The MiFID II suitability assessment is closely modelled on its predecessor provision in MiFID I. Suitability requirements apply to investment advice and portfolio management. These rules do not require a specific outcome, but are **process-based** and allow firms a degree of flexibility to take into account the nature of a client, the services provided and the products offered. The requirements are that an adviser/portfolio manager (a) gathers information about the relevant client (know your client), (b) assesses the suitability of the offered products or services for the client and (c) makes a personalised recommendation/trading decision on behalf of a client which reflects the client's profile. In the realm of portfolio management, it is considered a recommendation when a portfolio manager advises a client to give or alter a mandate to a portfolio manager that defines the limits of the portfolio manager's discretion.[143] In an advisory situation, the suitability obligation will only apply if

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142 ESMA, Guidelines for the assessment of knowledge and competence, 22 March 2016, ESMA/2015/1886

143 Recital 89 MiFID II Delegated Regulation.

the recommendation relates to a financial instrument.[144] The suitability assessment does not just relate to recommendations to buy financial instruments but includes the **advice not to buy, hold or sell** a financial instrument.[145]

1. Know your client

6 Investment firms are required to obtain from their clients and potential clients necessary information in three areas: (a) the person's knowledge and experience in the investment field relevant to the specific type of product or service being sold or advised on, (b) the person's financial situation including the ability to bear losses and (c) the person's investment objectives including risk tolerance. The aim of the **information gathering obligation** is to enable the firm to conduct the suitability assessment and to recommend investment services and financial instruments that are suitable to the client. Articles 54 and 55 of the MiFID II Delegated Regulation supplement the requirements to obtain certain information from a client or potential client in relation to the suitability assessment. The requirements are closely modelled on the suitability regime in MiFID I's Implementing Directive, which is why ESMA's 2012 guidelines on suitability[146] and ESMA's opinion on the application of the MiFID I regime to the sale and marketing of complex products[147] (which includes guidance on the suitability assessment) are still relevant for MiFID II, until ESMA updates these documents.[148]

7 According to Art 54(2) of the MiFID II Delegated Regulation, an investment firm must obtain from potential clients and clients such information as is necessary for the firm to understand the essential facts about the client and to have a 'reasonable basis for determining', having given due consideration to the nature and extent of the services provided, that a specific transaction satisfies three

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144 See the definition of investment advice in Art 4(1)(4).

145 Recital 87 MiFID II Delegated Regulation.

146 ESMA, Guidelines on certain aspects of the MiFID suitability requirements, 21 August 2012, ESMA/2012/387.

147 ESMA, Opinion on MiFID practices for firms selling complex products, 7 February 2014, ESMA/2014/146.

148 ESMA, Consultation Paper: Guidelines on certain aspects of the MiFID II suitability requirements, 13 July 2017, ESMA35-43-748.

criteria: (a) the transaction meets the client's investment objectives, including the client's risk tolerance; (b) the client is financially able to bear any related investment risks consistent with the client's investment objectives; and (c) the client must have the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of the portfolio. These **three criteria** are relevant to determining the content and the amount of information that must be gathered by an investment firm from a client. When a firm provides investment services to a professional client it is entitled to assume that point (c) above is satisfied in relation to the products, transactions and services for which the client is classified as professional.[149] The exception for professional clients applies for all types of professional clients, and to both investment advice and portfolio management. Where a firm provides investment advice to a professional client covered by Section 1 of Annex II to the MiFID II, it can also assume that point (b) is satisfied.[150] The exception relating to point (b) does not apply to portfolio management services or if a professional client is a reclassified retail client.

8 The **details of the information which investment firms are required to obtain from clients and potential client** are subject to the proportionality principle; and may vary depending on the complexity, risks and structure of the financial instrument, on the nature of the client, and on the nature and extent of the service provided.[151] It follows that with respect to transactions involving complex, risky or illiquid products, more in-depth information would need to be collected.[152] If limited services are provided, for instance if a portfolio manager is appointed to manage a specific portfolio, less information may be required. For example, a portfolio manager in such case may only need information on a client's risk tolerance in relation to the portfolio.[153]

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149 Art 54(3) subpara 1 MiFID II Delegated Regulation.

150 Art 54(3) subpara 2 MiFID II Delegated Regulation.

151 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.7; cf Art 54(2) MiFID II Delegated Regulation.

152 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.7.

153 Jonathan Herbst, *A practitioner's guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 143-144.

9 The information required to be collected concerning a potential client's or client's (referred to collectively as a 'client' in this section) financial situation includes, where relevant, information on the client's source and extent of regular income, assets, investments, real property, and the client's regular financial commitments (see Art 54(4) of the MiFID II Delegated Regulation). Information regarding a client's investment objectives include, where relevant, the client's investment time horizon, preferences for risk, risk profile and the purposes of an investment (see Art 54(5) of the MiFID II Delegated Regulation). Information related to a client's knowledge and experience includes, to the extent appropriate given the nature of a client, the nature and extent of the service to be provided and the type of product or transaction envisaged, the following: (a) the types of services, transactions and financial instruments with which the client is familiar, (b) the nature, volume and frequency of the client's transactions in financial instruments and the period over which they have been carried out and (c) the level of education and professional experiences of the client (see Art 55(1) of the MiFID II Delegated Regulation). It may not be necessary to gather all the information listed in Arts 54(4), (5) and Art 55(1), but a firm must be capable, on the basis of the information disclosed by a client, to conduct a suitability assessment. That may also mean that in a specific case a firm must obtain information that is not specifically listed in the **non-exhaustive lists of information** provided in the provisions discussed above.

10 Article 54(7) of the MiFID II Delegated Regulation contains a non-exhaustive list of steps that a firm is required to undertake in order to ensure that reasonable steps are taken to collect reliable information from a client. An investment firm is entitled to **rely on the information** provided by its clients and potential clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete (see Art 55(3) of the MiFID II Delegated Regulation). An investment firm is not under a general obligation to verify information provided by a client. When an investment firms has an on-going relationship with a client, it must have policies and procedures in place to maintain up-to-date information about the client.[154] If a firm becomes aware that information provided by a client about her/his existing liabilities is not

[154] Art 54(7) subpara 2 MiFID II Delegated Regulation.

accurate, it should refrain from giving investment advice or offering portfolio management services.[155] Additionally, an investment firm must not discourage a client or potential client from providing information required under Art 25(2).[156]

2. The suitability assessment

11 A suitability assessment has **three dimensions**. The dimensions relate to a client's investment objectives, financial ability to bear any related investment risks, and knowledge and experience (see Art 54(2) MiFID II Delegated Regulation). A suitability assessment is required each time an investment firm makes a recommendation to a client or makes a decision in relation to a portfolio. The specific transaction to be recommended or entered into must be compatible with respect to the relevant client in each of the three dimensions. If a firm provides investment advice recommending a bundled service/product package (see Art 24(11)), the overall bundled package must be suitable (see paragraph 2 of Art 25(2)). If an investment firm provides periodic suitability assessments to clients, it must review the suitability of the recommendations at least annually. The frequency of this assessment shall be increased depending on the risk profile of the client and the type of financial instruments recommended (see Art 54(13) of the MiFID II Delegated Regulation).

12 If advice or portfolio management services are provided to a professional client, any modifications (see discussion above at paragraph 7) to the information which is required to be gathered applies *mutatis mutandis* to the suitability assessment. Article 54(9) of the MiFID II Delegated Regulation requires investment firms to have adequate policies and procedures in place to (a) ensure that a firm understands the investment services and financial instruments selected for its clients, and (b) assess, taking into account cost and complexity, whether equivalent investment services or financial instruments can meet the client's profile. The latter requirement does not go as far as demanding that a firm assess whether an alternative instrument, less complex

155 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.7.

156 Art 55(2) MiFID II Delegated Regulation.

and with lower costs, would better meet the client's profile.[157] The relevant financial instrument or transaction must be suitable for the client, but it **does not need to be the most suitable financial instrument**. A transaction may, thus, be suitable for a client even if another transaction would have been more suitable.[158]

13 When undertaking to conduct a suitability assessment, an investment firm must inform the relevant client or potential client, in a clear and simply way, that the reason for assessing suitability is to enable the firm to act in the client's best interest.[159] Paragraph 2 of Article 54(1) of the MiFID II Delegated Regulation clarifies that for investment firms offering advice using **automated systems** to assist in making personal recommendations or trading decisions, the responsibility to undertake the suitability assessment is not affected. Article 54(1), thus, clarifies that the suitability standards for simplified advice[160] are the same as for other forms of investment advice. Article 54(6) of the MiFID II Delegated Regulation provides guidance on determining who would be the subject of a suitability assessment and how the assessment may be done in practice, including from whom information should be collected if a client is a legal person, a group of natural persons or is represented by another natural person.

14 Recital 82 of MiFID II highlights that the **responsibility to undertake a suitability assessment** lies with an investment firm. This responsibility cannot be delegated to a client, for example by simply asking whether a client has sufficient knowledge and experience in the relevant investment area. A transaction may be unsuitable for a client or potential client due to risks associated with the financial instruments, the type of transaction, the characteristics of an order or the frequency of trading.[161] A series of transactions, each of which are suitable when viewed in isolation, may be

157 Such was ESMA's proposal in ESMA, Consultation paper on MiFID II/MiFIR, 22 May 2014, ESMA/2014/549, 134.

158 Jonathan Herbst, *A practitioner's guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 148.

159 Art 54(1) subpara 1 sentence 2 MiFID II Delegated Regulation.

160 Simplified advice means advice that is limited to one or more of a client's specific needs and does not involve analysis of the client's circumstances that are not directly relevant to those needs.

161 Recital 88 MiFID II Delegated Regulation.

unsuitable if the recommendations or trades are made with a frequency that is not in the best interests of the client. In the case of portfolio management services, a transaction might also be unsuitable if it would result in an unsuitable portfolio.

15 If an investment firm does **not obtain the information** required under Art 25(2), the firm cannot make a recommendation (see Art 54(8) of the MiFID II Delegated Regulation), but may be able to proceed with a transaction on a non-advised basis if the requirements of Art 25(3) or Art 25(4) are met. If a specific financial instrument is unsuitable for a client, its purchase cannot be recommended to the client. If the firm nonetheless influences the client to proceed with the transaction on a non-advised basis, such behaviour would breach the MiFID II conduct-of-business rules.[162] It is, however, possible that an investment firm provides information to a client in order to increase the client's knowledge for the purposes of determining whether a transaction or service is suitable to that client.[163] Article 54(10) of the MiFID II Delegated Regulation clarifies that an investment adviser or portfolio manager shall not recommend or decide to trade where none of the relevant services or instruments are suitable for the client. If a client wishes to proceed with a transaction at her/his own initiative against the advice of the relevant investment firm that a specific financial instrument is not suitable for the client, the client must be clearly informed about the fact that the course of action is not suitable.[164] The 'unsuitable' transaction may be executed under the appropriateness test (see discussion below at paragraph 17) or under the execution-only regime (see discussion below at paragraph 21). If a client is unwilling to fully disclose information about her or his financial situation, it may still be possible to assess the suitability of a potential transaction so long as the firm is capable of assessing whether the client's assets are sufficient to bear

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162 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.6.

163 Martin Brenncke, 'Verständliche Risikoaufklärung und Schutz unkundiger Kleinanleger bei der Anlageberatung' (2014) 26 Journal of Banking Law and Banking 366, 372-373.

164 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.6.

any related investment risks, including any possible losses that may be incurred.[165]

16 Article 54(11) of the MiFID II Delegated Regulation targets the malpractice of **churning**. Before an investment adviser or portfolio manager may change a client's investments, it must undertake an analysis of the costs and benefits of the change, such that the firm is reasonably able to demonstrate that the benefits of any change are greater than the costs.

IV. Appropriateness (Art 25(3))

17 Article 25(3) requires an investment firm to gather information (know your client) and to assess whether the investment service or product envisaged is appropriate for the client (appropriateness assessment). The appropriateness assessment must be conducted before an investment firm offers investment services other than investment advice and portfolio management. The test for appropriateness is significantly less burdensome than the test for suitability discussed in the section above. In practice, the appropriateness assessment typically relates to **execution-only sales of complex products** which do not qualify for MiFID II's execution-only regime under Art 25(4), discussed below. The obligation to gather information requires an investment firm to ask a client or potential client for information[166] regarding that person's knowledge and experience with investments or services relevant to the specific type of product or service being offered.[167] The detailed information is set out in Arts 55 (see discussion above at paragraph 9) and 56 of the MiFID II Delegated Regulation. The depth and detail of the required information are subject to the proportionality principle. An investment firm is entitled to rely on the information provided by a client unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete (see Art 55(3) of the MiFID II Delegated Regulation).

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165 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.7.

166 Article 25(3) does not require the investment firm to actually obtain the information.

167 Examples of bad and good practices in the context of information relating to contracts for difference are provided in ESMA, Q & A relating to the provision of CFDs and other speculative products to retail investors under MiFID, 31 March 2017, ESMA/35-36-794, section 4, Question 1 paras 5, 6.

18 The **aim of the information gathering** required by Art 25(3) of MiFID II is to enable an investment firm to assess whether an investment service or product is appropriate for the relevant client, i.e. to determine whether the client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or investment service offered or sought.[168] An assessment of a client's financial situation or investment objectives is not required. In relation to a **professional client**, an investment firm is entitled to assume that a professional client has the necessary experience and knowledge of the products, transactions and services for which the client is classified as professional.[169] Therefore, the assessment for appropriateness does not add any additional obligations where a firm has ascertained that a client is a professional client. Where an investment firm plans to offer a bundle of services or products pursuant to Art 24(11), the appropriateness assessment must be undertaken in relation to the overall bundled package in accordance with the second sentence of Art 25(3).

19 An appropriateness assessment can be, but does not need to be, performed on a transaction-by-transaction basis. A client's knowledge and experience is, generally, unlikely to deteriorate over time. An investment firm may therefore identify a range of products or services carrying risks the client has the knowledge and experience to understand. The firm could proceed with a series of transactions and, at the time of each transaction, need only to assess that it fell within the permitted range.[170]

20 An investment firm is not required to inform a client that a transaction is appropriate for that client. If a firm makes such a statement to the client, there is a risk that doing so could amount to a personal recommendation, triggering the requirement that the investment firm conduct a suitability assessment.[171] Where an investment firm considers that a product or service is **not appropriate** for a client, or where a client does not provide the required information or provides insufficient information, a firm must warn the relevant

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168 Art 56(1) subpara 1 MiFID II Delegated Regulation

169 Art 56(1) subpara 2 MiFID II Delegated Regulation.

170 Jonathan Herbst, *A practitioner's guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 156.

171 Jonathan Herbst, *A practitioner's guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 157.

client (see paragraphs 2 and 3 of Art 25(3)). Yet, a firm may proceed with a transaction even in that case if the relevant client wishes to proceed with the transaction. A firm must not discourage a potential client or client from providing information generally required under Art 25(3).[172] Neither must an investment firm encourage a client to ignore a warning and proceed with a transaction.[173] Article 56(2) of the MiFID II Delegated Regulation specifies what records investment firms must maintain in relation to appropriateness assessments.

V. Execution-only (Art 25(4))

21 Article 25(4) creates the execution-only regime which applies to investment services which consist only of execution or reception and transmission of client orders. Article 25(4) also applies when, in the primary market, investment firms distribute financial instruments issued by them without providing any advice (see Recital 45 of MiFID II). Article 25(4)(a) identifies six classes of non-complex financial instruments which a firm may sell to a client without performing a suitability or appropriateness test. The final class listed, '**other non-complex financial instruments**', is further defined in Art 57 of the MiFID II Delegated Regulation, which specifies six criteria which a financial instrument must meet in order to be considered a non-complex financial instrument for the purposes of Art 25(4)(a)(vi). Complex products may only be sold on an advised basis or following an appropriateness assessment. With regard to three of the six classes of financial instruments referred to in Art 25(4)(a), execution-only services are excluded if the financial instrument involved incorporates a structure which makes it **difficult for the client to understand the risk involved**. ESMA's guidelines on complex debt instruments and structured deposits specify the criteria for the assessment whether debt instruments incorporate such a structure.[174] The guidelines also clarify the meaning of '**embedded derivatives**', a term expressly used in three of the six classes of financial instruments listed in Art 25(4)(a). Instruments explicitly excluded from the list of non-complex financial instruments in Art 25(4)(a)(i)-(v) are

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172 Art 55(2) MiFID II Delegated Regulation.

173 Jonathan Herbst, *A practitioner's guide to MiFID II* (2nd edn, Sweet & Maxwell 2015) 154, 157

174 ESMA, Guidelines on complex debt instruments and structured deposits, 4 February 2016, ESMA/2015/1787.

automatically deemed to be complex. These expressly excluded financial instruments cannot be considered as 'other non-complex financial instrument' under Art 25(4)(a)(vi).[175]

22 Article 25(4) further requires that the service is provided at the initiative of the client, that the client must be warned that an appropriateness assessment will not be performed in accordance with Art 25(3), and that, therefore, the client will not benefit from the protection which such an assessment may provide. Reflecting one aim of MiFID II, to enhance investor protection, and evidence that prior to the financial crisis retail investors were sold high risk and complex products,[176] Art 25(4) takes a tougher stance on the execution-only business than the previous regulatory regime under MiFID I and **limits the range of financial instruments** which firms can sell through execution-only distribution channels. In particular, Art 25(4) has removed structured UCITs from the category of non-complex products. It also prohibits investment firms from granting credits or loans (other than existing credit limits of loans, current accounts and overdraft facilities) to investors in conjunction with execution-only services in order to enable investors to carry out a transaction because loans increase a client's leverage, risk and the complexity of the transaction. Granting credits or loans may make it more difficult to understand the risks involved (see Recital 80 of MiFID II). Article 25(4) does not address (a) poor investor outcomes due to behavioural factors such as under-diversification or overconfidence, and (b) questions raised by excessive trading by retail investors.

23 Recital 85 of MiFID II clarifies that a service is considered to be provided **at the initiative of a client** (in all cases) unless a client demands the service in response to a personalised communication from, or on behalf of, a firm to the particular client and which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. The wording of Recital 85 of MiFID II ('unless') indicates that a **personalised**

175 ESMA, Final report: technical advice to the Commission on MiFID II and MiFIR, 19 December 2014, ESMA/2014/1569, 159; ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 10.1

176 Commission, Impact Assessment accompanying the MiFID II/MiFIR proposals, 20 October 2011, SEC(2011) 1226 final, 16.

communication to a particular client that does not contain an invitation and is not intended to influence the client in respect of a specific financial instrument or transaction may still be considered at the initiative of the client under Art 25(4)(b). An example of the latter category is a personal communication relating generally to the firm's brokerage services without identifying particular financial instruments or transactions. This condition set out in Art 24(4)(b) is also met if a client demands a service on the basis of any communication of a general nature containing a promotion or offer of financial instruments addressed to the public or a large group or category of (potential) clients (e.g. newspaper advert, public website).

VI. Client agreements (Art 25(5))

24 Article 25(5) creates a duty to establish a record of client agreements. It must be retained for at least the duration of the relationship with the relevant client.[177] Investment firms (other than investment advisers) are obliged to enter into a **written basic agreement** with each retail or professional client, in a durable medium, which sets out the essential rights and obligations of the firm and the client.[178] Investment advisers are also bound by this obligation but only when an adviser provides periodic suitability assessments.[179] Paragraph 2 of Article 58 of the MiFID II Delegated Regulation specifies the necessary contents of a client agreement. There are no express requirements as to the method of obtaining a client's consent to an agreement; consent is governed by national contract law. An investment firm is obliged to provide a client with the terms of the agreement under Art 46(1) of the MiFID II Delegated Regulation. The latter obligation and the record-keeping requirement under Art 25(5) apply to all client agreements, even if an investment firm is not positively required to enter into such an agreement.

VII. Reporting to clients (Art 25(6))

1. General reporting obligation

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177 Art 73 MiFID II Delegated Regulation.

178 Art 58 subpara 1 sentence 1 MiFID II Delegated Regulation.

179 Art 58 subpara 1 sentence 2 MiFID II Delegated Regulation.

25 The client reporting obligation set out in Art 25(6) of MiFID II aims to support monitoring of investment activities by investors and to strengthen investment firms' compliance incentives through the use of client reports, which must be provided to clients in a durable medium. MiFID II extends the reporting obligation to include periodic communications, taking into account the type and complexity of financial instruments involved and the nature of services provided to a client. The reporting obligation applies to all clients, but investment firms can agree with eligible counterparties to standards regarding the content and timing of reports which differ from those generally applicable to retail and professional clients (see Art 61 of the MiFID II Delegated Regulation).

26 Specific reporting requirements are set out in Arts 59 through 63 of the MiFID II Delegated Regulation in relation to the execution of orders, portfolio management activities and holding client assets. In respect of **portfolio management**, Art 60 of the MiFID II Delegated Regulation provides requirements for periodic statements, including their content and how often a statement must be provided to a client. A periodic statement must provide a fair and balanced review of the activities undertaken and of the performance of the portfolio during the relevant reporting period. A periodic statement does not have to be provided if clients have access to an **online system** that qualifies as a durable medium,[180] that contains up-to-date valuations of the client's portfolio and where the other conditions set out in Art 60(3)(a) of the MiFID II Delegated Regulation are satisfied. Portfolio managers need to inform a client when the overall value of the client's portfolio depreciates by 10%, and thereafter at multiples of 10% under Art 62(1) of the MiFID II Delegated Regulation. It is sufficient for this purpose if a portfolio manager evaluates the overall portfolio at least once each day, e.g. via a fixed portfolio valuation point for each day.[181] Investment firms that hold a retail client account that includes positions in leveraged financial instruments or contingent liability transactions must inform the client when the initial value of each instrument depreciates by 10% and thereafter at multiples of 10% (see Art 62(2) MiFID II Delegated

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[180] See Art 4(1) point 62 of the MiFID II for the definition of 'durable medium'.

[181] ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 8.1.

Regulation). It is sufficient if a firm sets a fixed daily valuation point for its leveraged financial instruments or contingent liability transactions in order to identify whether there has been a depreciation by 10% or more.[182]

27 Article 63 of the MiFID II Delegated Regulation stipulates the frequency and content of the **statement of client assets** that investment firms have to provide to clients if the firm holds client financial instruments or client funds. The statement shall not be provided if a client has access to an online system which qualifies as a durable medium and contains up-to-date statements of the client's financial instruments or funds, and where the other conditions of paragraph 3 of Art 63(2) of the MiFID II Delegated Regulation are fulfilled. Portfolio managers that hold financial instruments or funds can include a statement of client assets in the periodic statement the manager must provide to clients pursuant to Art 60(1) of the MiFID II Delegated Regulation.[183]

2. Suitability statement

28 A suitability statement is required under paragraph 2 of Art 25(6) when an investment firm provides **investment advice** to a retail client. The suitability statement must specify the advice given and how the advice meets the preferences, objectives and other characteristics of the retail client. This requirement is amplified by Art 54(12) of the MiFID II Delegated Regulation. For example, a suitability statement must indicate to a retail client whether the recommended services or instruments are likely to require the retail client to seek a periodic review of the arrangements.[184] That circumstance is likely to occur where advice is likely to be needed to rebalance a portfolio. The necessary level of detail required in a suitability statement must reflect the purpose of the report, which is to prove whether the recommendation given was, in fact, suitable for the client. It should contain the date and time of the day when the relevant advice was given,[185] and it must be provided in a durable

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182 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 8.3.

183 Art 63(3) MiFID II Delegated Regulation.

184 Art 54(12) subpara 2 MiFID II Delegated Regulation.

185 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.2.

medium before the relevant transaction is made. A durable medium may also be in electronic form (see Recital 82 of MiFID II).[186] A suitability statement can thus be made available to a client in a secured area of an investment firm's website, so long as the client receives a notification regarding the availability of the document.[187] According to ESMA, a suitability statement has to be provided to a retail client when that client has been provided with investment advice, irrespective of whether or not the advice is followed by a transaction and irrespective of the specific recommendation given, including **advice not to buy, hold or sell** a financial instrument.[188] Special conditions apply to suitability statements where the agreement to buy or sell a financial instrument is concluded using a means of distance communication that prevents the prior delivery of the suitability statement (see paragraph 3 of Art 25(6)). Where a firm is subject to several record-keeping and documentation obligations in connection with the provision of investment advice, e.g. the obligations set out in Arts 16(6), 25(6) and 16(7) in relation to records of face-to-face conversations, an investment firm may draft one single document so long as it complies with all corresponding requirements.[189]

29 When portfolio management services are provided to a retail client, or when an investment firm has informed a retail client that it will carry out a periodic assessment of suitability, the periodic report must contain an **updated suitability statement** in accordance with paragraph 4 of Art 25(6). An updated suitability statement may cover only the changes in the services provided or instruments involved, and/or any change in the circumstances of the client since the last statement, and may not need to include all the details contained in an earlier suitability statement.[190]

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186 See also Art 4(1)(62) MiFID II and Art 3 MiFID II Delegated Regulation.

187 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 2.3.

188 ibid, 2.1, 2.5.

189 ibid, 2.8.

190 Art 54(12) subpara 3 MiFID II Delegated Regulation.

Article 26 – Provision of services through the medium of another investment firm

Member States shall allow an investment firm receiving an instruction to provide investment or ancillary services on behalf of a client through the medium of another investment firm to rely on client information transmitted by the latter investment firm. The investment firm which mediates the instructions will remain responsible for the completeness and accuracy of the information transmitted.

The investment firm which receives an instruction to undertake services on behalf of a client in that way shall also be able to rely on any recommendations in respect of the service or transaction that have been provided to the client by another investment firm. The investment firm which mediates the instructions will remain responsible for the suitability for the client of the recommendations or advice provided.

The investment firm which receives client instructions or orders through the medium of another investment firm shall remain responsible for concluding the service or transaction, based on any such information or recommendations, in accordance with the relevant provisions of this Title.

I. General Features

1. Purpose

1 Article 26(1) and (2) of MiFID II facilitate, and make more efficient, the fulfilment of conduct-of-business obligations when an investment firm transmits (the 'mediating firm') an instruction to another investment firm (the 'dealing firm') to provide investment or ancillary services on behalf of a client of the mediating firm. In practice, the provision becomes relevant when external investment advisers or portfolio managers cooperate with investment firms to execute client orders.

II. Comment

2 Article 20 is applicable when an investment firm receives an instruction from another investment firm to provide investment or ancillary services on behalf of a client. In that case, the dealing investment firm knows that its services are for the end client. Article 20 does not apply if an investment firm is acting on its own behalf. Since the dealing investment firm ultimately concludes the service or transaction (see paragraph 3 of Art 26), it must, in principle, comply with the conduct-of-business obligations in relation to the ultimate client. This leads to **duplication of the conduct-of-business rules,** since the mediating investment firm is also required to fulfil its conduct-of-business obligations in relation to its client. For example, both the mediating and dealing firms would

need to categorise the client. Yet, the dealing investment firm often has no direct relationship with the ultimate client. Thus, it appears justified that the dealing investment firm can comply with the disclosure requirements under Arts 24(4), (5), the record keeping obligation pursuant to Art 25(5), and the reporting to clients requirement under Art 25(6) by employing the mediating investment firm as an agent.[191]

3 Articles 26(1) and (2) **facilitate** dealing investment firms, since dealing investment firms can rely on client information transmitted by the mediating investment firm, and on any recommendations in respect of the service or transaction that have been provided to the client by the mediating investment firm. A mediating investment firm remains responsible for the completeness and accuracy of the information it transmits and the suitability of the recommendations or advice provided to a client. If a mediating investment firm is a financial adviser or portfolio manager, the dealing investment firm can assume that the specific financial instrument or service is suitable for the client. If the mediating investment firm does not provide client information or if this information is incomplete, the dealing investment firm must obtain this information before providing the relevant service.[192]

Article 27 – Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to execution, which shall include all expenses incurred by the client which are directly relating to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

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191 cf Peter Mülbert, 'The eclipse of contract law in the investment firm-client-relationship: the impact of the MiFID on the law of contract from a German perspective' in Guido Ferrarini and Eddy Wymeersch (eds), *Investor protection in Europe: corporate law making, the MiFID and beyond* (Oxford University Press 2006) 299, 313 for Art 19(3), (8) MiFID I; Juliane Thieme, *Wertpapierdienstleistungen* (Nomos 2008) 453 for Art 19(7) MiFID I.

192 Juliane Thieme, *Wertpapierdienstleistungen* (Nomos 2008) 453.

For the purposes of delivering best possible result in accordance with the first subparagraph where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the investment firm's order execution policy that is capable of executing that order, the investment firm's own commissions and the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

2. An investment firm shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular trading venue or execution venue which would infringe the requirements on conflicts of interest or inducements set out in paragraph 1 of this Article and Article 16(3) and Articles 23 and 24.

3. Member States shall require that for financial instruments subject to the trading obligation in Articles 23 and 28 Regulation (EU) No 600/2014 each trading venue and systematic internaliser and for other financial instruments each execution venue makes available to the public, without any charges, data relating to the quality of execution of transactions on that venue on at least an annual basis and that following execution of a transaction on behalf of a client the investment firm shall inform the client where the order was executed. Periodic reports shall include details about price, costs, speed and likelihood of execution for individual financial instruments.

4. Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular, Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.

5. The order execution policy shall include, in respect of each class of financial instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.

Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. That information shall explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client. Member States shall require that investment firms obtain the prior consent of their clients to the order execution policy.

Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a trading venue, the investment firm shall, in particular, inform its clients about that possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a trading venue. Investment firms may obtain such consent either in the form of a general agreement or in respect of individual transactions.

6. Member States shall require investment firms who execute client orders to summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained.

7. Member States shall require investment firms who execute client orders to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements, taking account of, inter alia, the

information published under paragraphs 3 and 6. Member States shall require investment firms to notify clients with whom they have an ongoing client relationship of any material changes to their order execution arrangements or execution policy.

8. Member States shall require investment firms to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the investment firm's execution policy and to demonstrate to the competent authority, at its request, their compliance with this Article.

9. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 concerning:

(a) the criteria for determining the relative importance of the different factors that, pursuant to paragraph 1, may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client;

(b) factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders;

(c) the nature and extent of the information to be provided to clients on their execution policies, pursuant to paragraph 5.

10. ESMA shall develop draft regulatory technical standards to determine:

(a) the specific content, the format and the periodicity of data relating to the quality of execution to be published in accordance with paragraph 3, taking into account the type of execution venue and the type of financial instrument concerned;

(b) the content and the format of information to be published by investment firms in accordance with paragraph 6.

ESMA shall submit those draft regulatory technical standards to the Commission by 3 July 2015.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

I. General Features

1. Purpose

1 Best-execution obligations form a fundamental element of investor protection because the obligations mitigate against conflict of interest risk inherent when investment firms execute orders.[193] The best-execution obligations are also necessary to mitigate possible problems associated with market

193 Niamh Moloney, *EU securities and financial markets regulation* (3rd edn, Oxford University Press 2014) 519-520.

fragmentation.[194] Best execution aims to ensure that trading information made available under transparency obligations results in changes to the order-routing decisions of investment firms in order to seek out the best bargains for their clients.[195] Competition between trading venues is intended to improve the quality of execution services for end-investors and to cause trading volume to flow to the most efficient trading venue. MiFID II's best execution requirements are designed to promote both **market efficiency** generally, and lead to better results for **investors individually**. The central difficulty has been how to objectively measure best execution, which is difficult in respect of most asset classes with the exception of highly liquid shares. MiFID II aims at improving its best-execution rules by requiring greater transparency of the quality of execution services in different execution venues.[196]

2. Level 2 and 3 Measures

2 Level 2 measures in respect of Art 27 of MiFID II include the following: Art 64 (best execution criteria) and Art 66 (execution policy) of the MiFID II Delegated Regulation; the Commission Delegated Regulation (EU) 2017/575;[197] and the Commission Delegated Regulation (EU) 2017/576.[198]

II. The best possible results for clients (Art 27(1))

3 Article 27(1) contains the core obligation of the best-execution regime: Investment firms must take all sufficient steps to obtain, when executing orders, the best possible result for their clients. The obligation arises only where a firm executes orders on behalf of clients, i.e. when a firm owes contractual

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194 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 26; Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, 7.7.

195 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 14, 26.

196 cf Commission, Public consultation: review of MiFID, 8 December 2010, 63; Recital 92 MiFID II.

197 Commission Delegated Regulation (EU) 2017/575 of 8.6.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards concerning the data to be published by execution venues on the quality of execution of transactions (OJ EU, L 87/152).

198 Commission Delegated Regulation (EU) 2017/576 of 8.6.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the annual publication by investment firms of information on the identity of execution venues and on the quality of execution (OJ EU, L 87/166).

obligations to a client or has established an agency relationship with a client.[199] Recital 103 of the MiFID II Delegated Regulation clarifies that the MiFID II best-execution obligations apply when an investment firm deals on own account[200] with a client and the circumstances result in the firm acting on behalf of the client.[201] The best-execution obligation applies on an **order-by-order basis**: the selection of an entity or entities to execute an order, from among entities which are included in the execution policy of the relevant firm, must be done on an order-by-order basis.[202] That does not mean that an investment firm must obtain the best possible results for its clients on every single occasion. Rather, firms need to verify on an on-going basis that their execution arrangements work well throughout the different stages of the order-execution process.[203] The requirement that a firm take **'sufficient' steps** is a higher bar for compliance than was required under MiFID I, which required 'reasonable' steps. According to ESMA, the change to 'sufficient' highlights that firms' execution policies and arrangements must be able to detect potential deficiencies. Firms must not only monitor the quality of execution services, but also the quality of their execution arrangements and policies on an ex-ante and ex-post basis. If any deficiencies are detected, a firm must take all appropriate remedial action in order to demonstrate that they have taken 'all sufficient steps'.[204]

4 The obligation under Art 27(1) discussed above limits the possibility for internal execution to situations where this such execution would match, or better, the terms at which the client order could be finalised on a regulated market or in the wider market.[205] Since the best price may not always represent the best

199 Recital 91 MiFID II.

200 Dealing on own account is defined in Art 4(1)(6) MiFID II.

201 Recital 91 MiFID II circumscribes Recital 103 MiFID II Delegated Regulation; cf Commission, Best execution – scope issues under Mifid and the implementing directive, Working document ESC-07-2007, 19.3.2007, para 5.

202 Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, para 7.7.1.

203 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 1.1.

204 Ibid.

205 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 19.

possible result for the client,[206] the provision clarifies that the best possible result for the client is not only based on the price obtained, but also on other **factors** relevant to the execution of an order, such as trading costs, speed of execution, nature of the financial instrument and the order, likelihood of execution, and settlement or size. The flexibility of what constitutes best execution under MiFID II is also intended to foster competition between execution venues.[207] The second sentence of Art 27(1) provides autonomy to investors by providing that an investment firm must execute an order according to the specific instruction of a client if such an instruction exists. Article 64(2) of the MiFID II Delegated Regulation clarifies that a firm fulfils its obligation to take all sufficient steps to obtain the best possible result for a client to the extent that it follows specific instructions from a client relating to an order or specific aspects of an order. A firm can invite a client to choose between two or more specified trading venues, provided that those venues are consistent with the execution policy of the firm.[208]

5 Due to the limited ability of retail clients to monitor an investment firm for compliance with its best-execution obligations, Art 27(1) sets a clear benchmark for the execution of retail client orders:[209] The **total consideration** paid by a client, consisting of the price of the financial instrument and the costs of executing the order, including all expenses incurred by the client which are directly relating to the execution of the order, should be the most important factor in determining what constitutes the best possible result for the purposes of the best-execution obligation (see paragraph 2 of Art 27(1)). Even though MiFID II does not prescribe that the benchmark should be the total consideration of the order, when a firm executes an order on behalf of a professional client, it is justified to consider price and cost as relatively important to obtaining the best possible results for professional clients.[210]

206 Guido Ferrarini, 'Best execution and competition between trading venues – MiFID's likely impact' (2007) 2 Capital Markets Law Journal 404, 407.

207 Ibid.

208 Recital 102 MiFID II Delegated Regulation.

209 Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, para 7.7.3.

210 CESR, Q & A on best execution under MiFID, May 2007, CESR/07-320, 11.3.

6 When an investment firm assesses and compares execution venues[211] from among the venues included in the firm's execution policy to select a venue for a particular transaction, it must take into account its own commissions and the costs of executing the order on each of the eligible execution venues.[212] Investment firms may not structure their commissions in such a way as to discriminate unfairly between execution venues, e.g. by imposing different charges for different venues which do not reflect actual differences in execution costs to the firm.[213] An investment firm is, however, not obliged to compare the results of any order executed in accordance with its own execution policy, commissions and fees with the results that another investment firm could achieve applying different policies and parameters. Nor is an investment firm required to compare the differences in its own commissions which are attributable to differences in the nature of services provided to clients (see Recital 93 of MiFID II).

7 Article 64(1) of the MiFID II Delegated Regulation sets out, in general terms, the criteria which firms must take into account when determining the relative importance of the **different factors** which contribute to best execution as listed in Art 27(1). Best-execution obligations should be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments.[214] Article 64(4) of the MiFID II Delegated Regulation strengthens the best-execution standard in relation to OTC products by obliging firms to check the fairness of the price proposed to the client prior to the execution of the order. These checks must be undertaken on a systematic basis, embedded in firms' policies and practices, and require that appropriate valuation systems are in place.[215]

8 An investment firm transmitting or placing orders with other entities for execution may select a **single entity** to execute the firm's orders exclusively where an investment firm is able to show that the arrangement allows it to

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211 Defined in 64(1) subpara 2 MiFID II Delegated Regulation.

212 Art 27(1) subpara 3, Recital 93 MiFID II.

213 Art 64(3) MiFID II Delegated Regulation; Recital 95 MiFID II.

214 Recital 104 MiFID II Delegated Regulation.

215 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 1.2.

obtain the best possible result for its clients on a consistent basis, and where it can reasonably expect that the selected entity will enable it to obtain results for clients that are at least as good as the results that it reasonably could expect from using alternative entities for execution. The reasonable expectation should be supported by relevant data published in accordance with Art 27 or by internal analysis conducted by an investment firm.[216] When using only a single venue to execute orders, the specific way that an investment firm executes the order is important in fulfilling the best-execution obligation.[217] Using a single venue to execute orders does not diminish a firm's responsibility to monitor the quality of execution, nor the obligation to regularly assess the market landscape to determine whether or not there are alternative venues that the firm could use.[218]

III. Inducements for routing client orders (Art 27(2))

9 Article 27(2) clarifies that investment firms must not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular execution venue or entity which would infringe the relevant requirements on conflicts of interest or inducements. If a firm receives inducements from an execution venue, the investment firm must comply with Art 24(9) and inform its clients about the inducements in its execution policy.[219] Where a firm charges more than one participant in a transaction, to comply with regulations regarding inducements, it shall inform its clients in its execution policy of the value of any inducement received (see Art 66(7) of the MiFID II Delegated Regulation).

IV. Publishing periodic reports (Art 27(3)) and the top 5 execution venues (Art 27(6))

10 MiFID II requires trading venues, systemic internalisers, and execution venues to publish, without charge, data on the quality of execution services provided through the venue on at least an annual basis. These **periodic reports** must include details about price, costs, speed and likelihood of execution for

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216 Recital 100 MiFID II Delegated Regulation.

217 For details see ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 1.3.

218 Ibid.

219 Art 66(6) MiFID II Delegated Regulation.

individual financial instruments. According to ESMA, these reports should be kept available in the public domain for a minimum period of two years.[220] Investment firms must also inform clients on what venue orders have been executed. Commission Delegated Regulation (EU) 2017/575 further specifies the content, the format and the periodicity of data relating to the quality of execution services, taking into account the type of execution venue and the type of financial instrument concerned.

11 Increased transparency is intended to improve compliance with, and the ability to assess, best-execution obligations under MiFID II.[221] Investment firms must use the data provided by execution venues to compare and select the venues the firm uses on a regular basis.[222] Investment firms are, in turn, required to publish annually their **top-five execution venues** per class of financial instrument in terms of trading volume, as well as information about the quality of the execution services obtained (see Art 27(6)). This is ultimately intended to be a mechanism to allow the public and investors to compare the quality of execution practices among investment firms, and to improve clients' understanding and scrutiny of order execution quality.[223] Commission Delegated Regulation (EU) 2017/576 further specifies the content and the format of disclosures regarding the top-five most used execution venues by an investment firm, and on the quality of execution to be published by investment firms. According to ESMA, firms should keep these reports available in the public domain for a minimum period of two years.[224] Due to differences among how investment firms obtain the best possible result for retail clients, as compared to professional clients, the Regulation specifies that information about the top five execution venues must be provided separately for retail and professional clients. Annex I of the Commission Delegated Regulation (EU) 2017/576 sets out the relevant classes of financial instruments.

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220 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 1.4.

221 Commission, MiFID II proposal, 20 October 2011, COM(2011) 656 final, 8.

222 Recital 107 MiFID II Delegated Regulation.

223 Recital 1 Commission Delegated Regulation (EU) 2017/576; cf Recital 97 MiFID II.

224 ESMA, Q & A on MiFID II and MiFIR investor protection and intermediaries topics, 10 July 2017, ESMA35-43-349, 1.4.

V. Order execution policies (Arts 27(4), (5), and (7))

12 Investment firms must have effective processes in place to ensure compliance with the core best-execution obligation. In particular, firms must establish and implement an order execution policy under Art 27(4). Formulating this policy generally involves a **three-step approach**.[225] First, (1) an investment firm should establish the relative importance of, or at least a process for establishing the relative importance of, the execution factors mentioned in Art 27(1), taking into account the criteria listed in Art 64(1) of the MiFID II Delegated Regulation. Second, (2) in accordance with Art 27(5), a firm should analyse the available execution venues, select those venues that enable it to obtain the best possible result on a consistent basis, and take the necessary steps to make it possible to execute its client orders on those venues. Third, (3) client orders should be routed, on an order-by-order basis, to the appropriate venues, taking into account the relative importance of the execution factors as set out in the firm's policy.

13 When determining what execution venues should be included in a firm's execution policy (see Art 27(5)), an investment firm's own commissions or fees charged to the client for the provision of an investment service should not be taken into account (Recital 94 of MiFID II). MiFID II also clarifies that an investment firm violates its best-execution obligations if it charges a different commission or spread to clients for execution on different execution venues and that difference does not reflect actual differences in the cost to the firm of executing on the relevant venues.[226] Investment firms must also **disclose appropriate information** to their clients about their order execution policy which explains, clearly, in sufficient detail, and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the relevant client (see Art 27(5)). Article 27(5) regulates the manner of disclosure, which resulted from concerns that information provided by investment firms in order execution policies under the MiFID I rules was often

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[225] Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, para 7.7.1; cf Recital 99 MiFID II Delegated Regulation.

[226] Recital 95 MiFID II.

generic and formulaic.[227] Firms must also obtain the prior consent from their clients to the order execution policy, which may be obtained, for example, when establishing the business relationship. Paragraph 3 of Art 27(5) targets execution of orders performed outside a trading venue and reflects MiFID II's aim that trading be organised on regulated trading venues. Paragraph 3 of Art 27(5) requires that investment firms obtain the prior express consent of their clients before proceeding to execute orders outside a trading venue.

14 Articles 66(2) through (9) of the MiFID II Delegated Regulation sets out specific requirements relating to the **content of an execution policy**. Requirements of an execution policy include, for example, that (a) the information on the execution policy shall be customised depending on the class of a financial instrument and the type of the service provided, and that (b) the execution policy shall be provided to a client in good time and prior to the provision of the relevant service. A firm has to include a list of the venues that the firm ordinarily uses, as well as a list of the quantitative and qualitative factors used to select an execution venue on the list. Where an investment firm executes orders for retail clients, it must provide those clients with a summary of the relevant policy, focused on the total costs they incur. The order execution policy should take into account the particular characteristics of securities financing transactions, and it should list execution venues for these transactions separately.[228]

15 Article 27(7) requires investment firms to **monitor** the effectiveness of their order execution arrangements and execution policies in order to identify and correct any deficiencies. A firm must notify clients with whom it has an ongoing client relationship of any material changes to its order execution arrangements or execution policy. Article 66(1) of the MiFID II Delegated Regulation sets out the requirements for when a review of the execution policy and order execution arrangements must occur. Investment firms are required to review their execution policy and order execution arrangements at least annually, and also whenever a material change occurs that affects the firm's ability to obtain the best possible result for the execution of its client orders. A material change is a

227 Recital 97 MiFID II.

228 Recital 99 MiFID II Delegated Regulation.

significant event that could impact best-execution factors referred to in Art 27(1).[229]

Article 28 – Client order handling rules

1. Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.

Those procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.

2. Member States shall require that, in the case of a client limit order in respect of shares admitted to trading on a regulated market or traded on a trading venue which are not immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately that client limit order in a manner which is easily accessible to other market participants. Member States may decide that investment firms comply with that obligation by transmitting the client limit order to a trading venue. Member States shall provide that the competent authorities may waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 4 of Regulation (EU) No 600/2014.

3. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to define:

(a) the conditions and nature of the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as to obtain more favourable terms for clients;

(b) the different methods through which an investment firm can be deemed to have met its obligation to disclose not immediately executable client limit orders to the market.

I. General Features

1. Purpose

1 The rules applicable to handling client orders are designed to enhance confidence in the impartiality and quality of execution services. Article 28 above aims to ensure that client orders are processed expeditiously and according to objective rules of precedence and priority. Article 28 also is intended to ensure that an investment firm takes active steps to facilitate executing client orders,

229 Art 65(7) subpara 4 MiFID II Delegated Regulation.

and that clients' interests are not adversely affected by self-interested or negligent handling by a firm.[230]

2. Level 2 and 3 Measures

2 Level 2 measures includes the following articles of the MiFID II Delegated Regulation: Art 67 (client order handling: general principles), Art 68 (aggregation and allocation of orders), Art 69 (aggregation and allocation of transactions for own account), and Art 70 (prompt fair and expeditious execution of client orders and publication of unexecuted client limit orders for shares traded on a trading venue).

II. General principles (Art 28(1))

3 Investment firms authorised to execute orders on behalf of clients must implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or proprietary transactions of the investment firm. This differs from the best execution standard, which refers to the quality of execution of a client order relative to conditions in the wider marketplace.[231] What is required under Art 28 is **timely execution**, not best execution. Articles 67 through 70 of the MiFID II Delegated Regulation specify the conditions applicable to a firm's procedures and arrangements to execute orders, which are to ensure prompt, fair and expeditious execution of client orders. Client orders must be promptly and accurately recorded and allocated under Art 67(1)(a) of the MiFID II Delegated Regulation. Firms must execute otherwise **comparable client orders** in accordance with the time an order is received (first come, first served under paragraph 2 of Art 28(1)). Orders must be executed sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or if the interests of the relevant client require otherwise.[232] The characteristics of an order may also depend on the channel through which an order is received. Client orders should not be treated as otherwise comparable

230 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 19, 27.

231 ibid, 27.

232 Art 67(1)(b) MiFID II Delegated Regulation.

if they are received by different media, and if it would not be practicable to treat them sequentially.[233] If a material difficulty relevant to the proper carrying out of an order arises, the firm must inform a retail client about it promptly upon becoming aware of the difficulty.[234]

4 In order to avoid risk of abuse by an investment firm, Art 67(2) of the MiFID II Delegated Regulation requires that any financial instruments belonging to a client and funds belonging to a client received in settlement of an executed order must be promptly and correctly delivered to the account of the appropriate client. Article 67(3) of the MiFID II Delegated Regulation addresses the risk of market abuses and protects investors from the '**front-running**' of their orders by prohibiting investment firms from misusing information relating to pending client orders, and requiring firms to take all reasonable steps to prevent such misuse by any relevant persons. This is clarified by Recital 110 of the MiFID II Delegated Regulation, which states that dealing on own account on the basis of the information of pending client orders should be considered misuse of information.

III. Aggregation and allocation of client orders

5 Article 68 and 69 of the MiFID II Delegated Regulation details the conditions under which client orders may be aggregated with other client orders or with the investment firm's own transactions for the purposes of executing the orders, and how aggregated orders must be allocated. **Conflicts of interest** often arise when transactions are aggregated and when, at the settlement stage, the aggregated trades are allocated to accounts of the individual clients. The regulatory requirements apply the principle that only clients should gain an advantage from order aggregation.[235] An order from a client or for a firm's own account may only be aggregated with client orders if it is unlikely that the aggregation will work overall to the disadvantage of any client whose order is to be aggregated, and if the other conditions of Art 68(1) of the MiFID II Delegated Regulation are fulfilled. Investment firms must also establish and

233 Recital 110 MiFID II Delegated Regulation.

234 Art 67(1)(c) MiFID II Delegated Regulation.

235 Commission, Background note to draft MiFID I Implementing Directive, 6 February 2006, para 7.8.

effectively implement an **order allocation policy** which provides for the fair allocation of aggregated orders and transactions. Investment firms which have aggregated transactions for own account with one or more client orders must not allocate the related trades in a way that is detrimental to a client (see Art 69(1) of the MiFID II Delegated Regulation). The reallocation of transactions will be considered to be detrimental to a client if unfair precedence is given to the relevant investment firm or to any particular client.[236]

IV. Client limit orders (Art 28(2))

6 Article 28(2) introduces a pre-trade transparency requirement related to limit orders[237] if the relevant shares are admitted to trading on a regulated market or traded on a trading venue. The article is a safeguard for market efficiency. The rule requires firms to publicize such client limit orders, and aims to ensure that investment firms do not withhold price-relevant information, embodied in the terms of an unexecuted client limit order, from other market participants.[238] Article 70 of the MiFID II Delegated Regulation specifies the requirement to publish unexecuted client limit orders. The obligation to make public unexecuted client limit orders does not apply if the client that placed the order expressly instructs otherwise or if the Member State has decided to waive this obligation in respect of large transactions (see sentence 4 of Art 28(2)).

Article 29 – Obligations of investment firms when appointing tied agents

1. Member States shall allow an investment firm to appoint tied agents for the purposes of promoting the services of the investment firm, soliciting business or receiving orders from clients or potential clients and transmitting them, placing financial instruments and providing advice in respect of such financial instruments and services offered by that investment firm.

2. Member States shall require that where an investment firm decides to appoint a tied agent it remains fully and unconditionally responsible for any action or omission on the part of the tied agent when acting on behalf of the investment firm. Member States shall require the investment firm to ensure that a tied agent discloses the capacity in which he is acting and the investment firm which he is representing when contacting or before dealing with any client or potential client.

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236 Recital 109 MiFID II Delegated Regulation.

237 Limit order is defined in Art 4(1)(16).

238 Commission, MiFID I proposal, 19 November 2002, COM(2002) 625 final, 21.

Member States may allow, in accordance with Article 16(6), (8) and (9), tied agents registered in their territory to hold money and/or financial instruments of clients on behalf and under the full responsibility of the investment firm for which they are acting within their territory or, in the case of a cross border operation, in the territory of a Member State which allows a tied agent to hold client money.

Member States shall require the investment firms to monitor the activities of their tied agents so as to ensure that they continue to comply with this Directive when acting through tied agents.

3. Tied agents shall be registered in the public register in the Member State where they are established. ESMA shall publish on its website references or hyperlinks to the public registers established under this Article by the Member States that decide to allow investment firms to appoint tied agents.

Member States shall ensure that tied agents are only admitted to the public register if it has been established that they are of sufficiently good repute and that they possess the appropriate general, commercial and professional knowledge and competence so as to be able to deliver the investment service or ancillary service and to communicate accurately all relevant information regarding the proposed service to the client or potential client.

Member States may decide that, subject to appropriate control, investment firms can verify whether the tied agents which they have appointed are of sufficiently good repute and possess the knowledge and competence referred to in the second subparagraph.

The register shall be updated on a regular basis. It shall be publicly available for consultation.

4. Member States shall require that investment firms appointing tied agents take adequate measures in order to avoid any negative impact that the activities of the tied agent not covered by the scope of this Directive could have on the activities carried out by the tied agent on behalf of the investment firm.

Member States may allow competent authorities to collaborate with investment firms and credit institutions, their associations and other entities in registering tied agents and in monitoring compliance of tied agents with the requirements of paragraph 3. In particular, tied agents may be registered by an investment firm, credit institution or their associations and other entities under the supervision of the competent authority.

5. Member States shall require that investment firms appoint only tied agents entered in the public registers referred to in paragraph 3.

6. Member States may adopt or retain provisions that are more stringent than those set out in this Article or add further requirements for tied agents registered within their jurisdiction.

I. General Features

Purpose

1 MiFID II's regime governing tied agents protects investors by requiring tied agents to possess certain professional requirements, and by stipulating that investment firms are fully and unconditionally responsible for activities carried out by its tied agents.

II. Comment

2 Article 29(1) of MiFID II obliges Member States to allow investment firms to appoint tied agents. Article 4(1)(29) of MiFID II defines ‘tied agent’. A tied agent may only have **one master**, i.e. a tied agent may act on behalf of only one investment firm. If a person provides investment services on behalf of more than one investment firm, the person is not a tied agent but an investment firm, in accordance with Recital 99 of MiFID II. Investment firms may have multiple tied agents. The **defining characteristic** of the MiFID II regime governing tied agents is that the appointing investment firm remains fully and unconditionally responsible for its agents while acting on behalf of the investment firm (see paragraph 1 of Art 29(2)). An investment firm must monitor the activities of its tied agents and comply with MiFID II when acting through tied agents.[239] An investment firm must also ensure that a tied agent discloses the capacity in which the agent is acting, and for what firm, to a client before the agent deals with that client (see paragraph 1 of Art 29(2)). Furthermore, an investment firm must monitor the activities of its tied agents in order to ensure that it complies with MiFID II when acting through the tied agents (see paragraph 3 of Art 29(2)). The **permitted scope of activities** which a tied agent may perform on behalf of an investment firm is exhaustively listed in Art 29(1).[240] Yet, tied agents have the right to undertake activities not covered by MiFID II, for example, distributing insurance contracts.[241] These other activities must not have any negative impact on the activities carried out by the tied agent on behalf of an investment firm under Art 29(4).

3 A Member State can adopt or retain additional rules in relation to tied agents registered within its jurisdiction in accordance with Art 29(6). A Member State has discretion to allow tied agents registered in its territory to hold clients’ money and financial instruments within its territory, in accordance with the MiFID II asset protection regime. In the case of cross border activities, a Member State may also, but is not required to, allow a tied agent registered in its territory to hold a client’s money and financial instruments in the territory of

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239 Art 29(2) subpara 3.

240 Juliane Thieme, *Wertpapierdienstleistungen* (Nomos 2008) 481 for Art 23(1) MiFID I.

241 Recital 100 MiFID II.

another Member State which allows tied agents to hold the same (see paragraph 2 of Art 29(2)). A tied agent must be registered in a **public register** in the Member State where the agent is established (see Art 29(3)). A tied agent must be of sufficiently good repute and possess the professional standards set out in paragraph 2 of Art 29(3). Member States' competent authorities should not register, or should withdraw the registration of, any tied agent where the activities performed by the agent indicate clearly that the tied agent has registered in a particular Member State for the purpose of evading the stricter standards in force in another Member State within the territory of which the agent intends to carry out, or does carry out, the greater part of his or her activities.[242]

Article 30 – Transactions executed with eligible counterparties

1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Article 24, with the exception of paragraphs 4 and 5, Article 25, with the exception of paragraph 6, Article 27 and Article 28(1) in respect of those transactions or in respect of any ancillary service directly relating to those transactions.

Member States shall ensure that, in their relationship with eligible counterparties, investment firms act honestly, fairly and professionally and communicate in a way which is fair, clear and not misleading, taking into account the nature of the eligible counterparty and of its business.

2. Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Union law or under the national law of a Member State, national governments and their corresponding offices including public bodies that deal with public debt at national level, central banks and supranational organisations.

Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 24, 25, 27 and 28.

3. Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.

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242 Recital 102 MiFID II.

Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Member States shall allow the investment firm to obtain that confirmation either in the form of a general agreement or in respect of each individual transaction.

4. Member States may recognise as eligible counterparties third country entities equivalent to those categories of entities referred to in paragraph 2.

Member States may also recognise as eligible counterparties third country undertakings such as those referred to in paragraph 3 on the same conditions and subject to the same requirements as those laid down in paragraph 3.

5. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify:

(a) the procedures for requesting treatment as clients under paragraph 2;

(b) the procedures for obtaining the express confirmation from prospective counterparties under paragraph 3;

(c) the pre-determined proportionate requirements, including quantitative thresholds that would allow an undertaking to be considered to be an eligible counterparty under paragraph 3.

I. General Features

1. Purpose

1 Many of the MiFID II's rules of conduct do not apply when investment firms authorised to execute orders on behalf of clients, and/or to deal on own account, and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties (see paragraph 1 of Art 30(1)). The reason MiFID II rules of conduct do not apply is that these market transactions are characterised by **arm's length**.

2. Level 2 and 3 Measures

2 Level 2 measures related to Art 30 of MiFID II include Art 71 of the MiFID II Delegated Regulation (eligible counterparties).

II. Comment

3 The regime governing transactions between investment firms and eligible counterparties, as defined in Art 30(2) above, is only applicable in relation to investment services described by paragraph 1 of Art 30(1). For other

investment services, the rules of conduct with respect to professional clients will normally apply. Investment firms providing services which are mentioned in Art 30(1) to eligible counterparties are not obliged to comply with a number of MiFID II's rules, including best execution (discussed further under Art 27 above) and client order-handling requirements aimed at protecting investors. Compared to its predecessor regulation, Art 24 of MiFID I, Art 30(1) of MiFID II extends some **investor protection measures** to eligible counterparties, primarily in relation to information obligations: Investment firms must (a) act honestly, fairly and professionally in their dealings with eligible counterparties, (b) communicate in a way which is fair, clear and not misleading, (c) fulfil the disclosure requirements under Arts 24(4) and (5), and (d) meet reporting obligations under Art 25(6). These rules are the result of experiences during the financial crisis, when minimal investor protections failed to achieve satisfactory outcomes for non-retail clients, and exist because the ability of some eligible counterparties to appreciate the risk of their investments is limited.[243] The obligations of investment firms to assess the suitability and appropriateness of a product or service do not apply vis-à-vis eligible counterparties.

4 Eligible counterparties are **clients**.[244] Amplifications of the investor protection measures for eligible counterparties as set out in the MiFID II Delegated Regulation, that apply to all clients and potential clients, also apply to eligible counterparties. Investor protection measures in MiFID II delegated legislation that apply only to retail or professional clients (e.g. Art 44 of the MiFID II Delegated Regulation specifying the conditions for fair, clear and not misleading information) do not apply to eligible counterparties.

5 Paragraph 1 of Art 30(2) lists entities that Member States must recognise as eligible counterparties. **Municipalities and local public authorities** are excluded from that list due to concerns arising from the sale of inappropriate or unsuitable complex instruments during the financial crisis. Article 30(3) and (4) refer to undertakings that Member States may recognise as eligible

243 Recital 104 MiFID II; Commission, MiFID II proposal, 20 October 2011, COM(2011) 656 final, 2.

244 Recital 103 MiFID II.

counterparties. Eligible counterparties have the right to request, either generally or on a trade-by-trade basis, to be treated as clients whose business is subject to the full range of rules of conduct under paragraph 2 of Art 30(2). Article 30(2) and (3) are amplified by Art 71 of the MiFID II Delegated Regulation. Investment firms may also, on their own initiative, treat a client as a professional or retail client where that client might otherwise be classified as an eligible counterparty.[245]

6 The actual impact of the increased level of investor protection granted to eligible counterparties by MiFID II on market practices under MiFID I is unclear. There has not yet been any guidance or further clarification by ESMA as to the meaning of acting honestly, fairly and professionally or communicating in a manner that is fair, clear and not misleading in relation to eligible counterparties.

245 Art 45(3)(a) MiFID II Delegated Regulation.