Financial Services Commission

Guidance Note

Suitability, Appropriateness and Best Execution

Markets in Financial Instruments Directive (MiFID)

Issued : 01 November 2007

Table of Contents

Published by:

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1. Introduction

The Markets in Financial Instruments Directive (MiFID) came into effect on 01 November 2007, when it replaced the Investment Services Directive (ISD). MiFID was implemented in Gibraltar via the Financial Services (Markets in Financial Instruments) Act 2006 ("the Act") and the Financial Services (Markets in Financial Instruments) Regulations 2007 ("the Regulations")[1].

The aim of this Guidance Note is to supplement the legislation in regard to Suitability, Appropriateness and Best Execution.

1.1. Suitability and Appropriateness

The provision of investment advice[2] under MiFID requires a firm to assess a client before providing a recommendation. The product or service offered will determine the amount of information a firm will have to collect.

An overview of the main areas to consider with regards to Suitability and Appropriateness under MiFID are that:

- Firms have an obligation to assess suitability for all clients when providing investment advisory or discretionary portfolio management services.
- A firm must obtain the necessary information to assess suitability otherwise it cannot make a personal recommendation to the client or take a decision to trade for the client. This should include factors such as knowledge and experience.
- Firms are required to test for appropriateness where it provides investment services **<u>other than</u>** investment advice or discretionary portfolio management, for instance, where providing dealing services.
- A warning is to be issued where a client wishes to proceed to invest in a product which has been classed by the firm as inappropriate and where a client does not provide sufficient information for a firm to judge their appropriateness.

1.1.1. Suitability

The requirement to carry out a suitability test only applies to firms when carrying out investment advice, resulting in a personal recommendation to a client, or discretionary portfolio management, resulting in the portfolio manager making trading decisions on behalf of a client, for an investment service and financial instruments.

There is no requirement to conduct a suitability test for execution-only business.

The rationale behind such a test is to ensure that a firm takes reasonable steps to ascertain that a personal recommendation, or decision to trade, is suitable for its clients.

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[1] Can be accessed via http://www.gibraltarlaws.gov.gi/articles/2007s120.pdf

[2] Investment advice is defined as the provision of personal recommendation to a client, either upon their request or at the initiative of the investment firm in respect of one or more transactions relating to financial instruments

1.1.2. Appropriateness

The appropriateness test applies to firms carrying on services other than investment advice or discretionary portfolio management in the course of MiFID business therefore it applies to all non-advised services and execution-only transactions. If an activity falls out of the scope of investment services, as described in the MiFID Glossary of terms guidance note, the appropriateness requirement does not apply.

The appropriateness test also need not be applied where the execution-only business is limited to non-complex products.

1.1.3. General requirements

Firms must act after having considered their overarching duty to act in the interests of the client and therefore cannot recommend a product or service that they have assessed as unsuitable for that particular client. If the client wishes to proceed, a warning must be issued.

As with suitability, it is possible that a firm may already assess appropriateness as a matter of commercial prudence in any case.

The following points are to be considered in view of compliance with suitability and appropriateness requirements:

- Whether the suitability obligation or the appropriateness obligation applies to the transactions under consideration.
- Whether the firm has established a process for assessing suitability and appropriateness.
- Whether the firm has implemented a procedure to ensure information is updated regularly.
- Whether the firm has established a process for reviewing suitability and appropriateness process/policy in the event of a material change.
- Whether a warning is required, which should be clear and prominent, advising that the product or service may not be appropriate for a client.
- What systems are in place for recording client details and any relevant correspondence with clients
- What record keeping mechanisms are in place that adequately record the manner in which suitability and appropriateness have been assessed for each client.

1.2. Best Execution

The purpose of Best Execution is to promote market efficiency and investor protection by ensuring that the client of a firm is well informed and receives the best possible result.

There is an overarching requirement for firms which are subject to MiFID's best execution requirements to take all reasonable steps to obtain the best possible result for the execution of client orders.

The requirements apply to:

a) Firms that execute client orders for MiFID financial instruments, and

b) Firms that receive and transmit orders to third parties, or

c) Firms that manage portfolios and place orders for execution with third parties.

Best Execution requirements do not apply to those firms which fall under the definition of an eligible counterparty as defined under Section 24 of the Act..

The differences in the requirements focus on the functions the firm typically performs, for example the establishment and maintenance of an execution policy varies depending on the services provided by the firm.

The main areas to consider concerning Best Execution under MiFID are that:

- Firms cannot opt out of the obligation to take all reasonable steps to obtain the best possible result when executing client orders in the absence of specific instructions, apart from those services offered to eligible counterparties.
- The obligation is to be met for all types of products although the same approach need not be used in all cases.
- Whilst the best possible result is to be obtained this does not necessarily mean that the best price is to be obtained.
- It is a requirement to establish and implement an order execution policy and to obtain client consent to such policy prior to executing orders.

2. Suitability

2.1. Obtaining information

A firm should perform what is essentially an information gathering exercise similar to the 'Know Your Customer' requirements. The test of suitability requires a firm to have obtained "relevant" information from a client or potential client in order to assess suitability and thus recommend, or take a decision to trade in, the investment services and financial instruments that may be suitable for the client. Information should cover the client's:

- Investment objectives
- Financial situation
- Knowledge and experience

What is classed as "relevant" will vary from case to case, and as such the firm will have considerable discretion to decide upon the required information in each particular instance.

Firms can decide for themselves how they obtain the necessary information relating to clients. For example, depending on the type of service and the complexity of the product, firms may require clients to complete a standardised questionnaire, a tailored questionnaire or a combination of both.

Firms can use publicly available information, or non-publicly available information provided this does not breach any confidentiality provisions or obligations, for the purpose of information gathering. Information may also be obtained in a meeting with the client, a telephone conversation or an e-mail interchange. Any of these methods will suffice subject to these being properly recorded and documented.

A firm must not discourage a client from providing any of the information required nor from updating any information held by the firm. If the relevant information is not obtained the firm must not make a recommendation, nor in this respect act for, or on behalf, of that client.

2.2. Level of detail of information

The level of detail of information required from clients will depend on the type of service being provided and the client's circumstances. Firms therefore have to consider the nature of the services being provided.

The information required is only that which is "relevant" to test suitability. As there are several types of services which are subject to the suitability requirements, the level of information that may be considered "relevant" will differ from one type of service to another.

For example in the case where ad-hoc advice is to be provided a full review of the client's entire portfolio would need to be undertaken and information covering the client's overall objectives, knowledge and financial situation would have to be collated. Whereas if the client requests advice relating to a specific instrument or an existing investment then the information required would be in regard to the client's objectives and knowledge in relation to that particular investment.

In relation to discretionary portfolio management, if this approach was applied, the level of detail required around suitability would depend upon whether the mandate relates to the whole of the client's portfolio or only a portion of the portfolio, and whether the firm sets the investment strategy or whether this is dictated by the client.

There is no eligible counterparty classification for investment advisory and discretionary portfolio management services. A client that would otherwise be classified as an eligible counterparty must be treated as a professional client for these services. However, a firm may still apply its discretion when dealing with such clients and conclude that the level of detail of information required to assess suitability is more limited because of the size and sophistication of the client.

2.2.1. Investment Objectives

The information regarding the investment objectives of a client must include, where relevant, information on:

- The length of time for which the client wishes to hold the investment i.e. short, intermediate or long term.
- Risk profile and preferences regarding risk taking - keeping capital safe and avoiding any risk, accepting a low risk to achieve some level of a profit or accepting an appropriately higher level of risk to achieve a higher profit /return expectation.
- The purposes of the investment – for example, hedging.

Both professional clients and retail clients will need to be asked to provide information about their investment objectives (for the definitions of the different classifications of clients please refer to the Client Categorisation guidance note).

2.2.2. Financial situation

Information regarding the financial situation of a client must include, where relevant, information on:

- The source and extent of the client's regular income.

- Assets, including liquid assets, investments and real property.
- Regular financial commitments.

Even where information relating to the client's financial situation is necessary, a firm only needs to obtain the necessary information to understand the essential facts about the client to enable the firm to offer the service or financial instrument required.

When collecting information, firms are to also consider the type of product, service or transaction to be recommended or entered into and the nature of the client.

In regards to the type of product offered, firms should consider the size of the proposed investment and the range of financial products in respect of which the firm intends to advise or provide discretionary portfolio management services.

Where the client only seeks advice on investments in very low risk and non-complex products and is investing a relatively small amount, the amount of information the firm may consider necessary in respect of the client's financial situation may be much less than the amount of information required if the client was interested in highly structured and complex credit derivatives and was investing a large amount.

At a later stage if the client decides to invest in a more complex product the firm may wish to obtain more information in respect of the client if the information initially obtained is not sufficient to test the client's suitability for that particular product.

Information relating to a client's financial situation is not required when providing discretionary portfolio management services to institutional asset management clients[3]. In such cases firms can assume that information about the client's financial situation is not necessary since such clients are per se professional clients.

In addition, if the client is a per se professional client receiving investment advice, the firm can also assume that the client is able to financially bear any related investment risks consistent with the investment objectives of that client. However a firm must not assume the ability to bear financial loss for a retail client, nor when providing discretionary portfolio management services to **any type of client.**

2.2.3. Client knowledge and experience

Information in relation to a client's knowledge and experience in the investment field, relevant to the specific type of product or service, is to include:

- The types of services, transactions and financial instruments with which the client is familiar
- The nature, volume, and frequency of the client's transactions in financial instruments and the period over which they have been carried out

[3] For example other regulated investment firms, credit institutions, insurance companies, collective investment schemes and their management companies, other financial institutions subject to EU or Member State authorisation or regulation, governments, central banks.

- The level of education, and profession or relevant former profession of the client or potential client.

The above information is to be collated, to the extent appropriate, considering the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including the complexity and the risks involved.

The level of education, profession or relevant former profession of the client is to be considered when looking at the nature of the client. For example, individuals who have a finance related professional background or qualifications, are more likely to understand the risks in complex products than individuals who do not have such a background. Conversely, firms should also pay due care and attention during the sales process to whether a client is illiterate or consider other factors which could prevent or impact on understanding - for example, when product documentation is in a language that is not the client's first language.

In the case of corporate clients the level of knowledge and experience within the corporate entity can be measured by considering past investment history. The firm can also take into account the knowledge and experience of individuals authorised to make investment decisions on behalf of the corporate as a whole.

Factors that might contribute to a determination concluding that a client already has appropriate knowledge and experience may include cases where the firm has provided information to the client about, or the client is already familiar with, the nature of the product or service and the risks that it entails.

One of the ways in which a firm may be able to ensure that the client has appropriate information in respect of the risks associated with a particular product is by providing the client with information/risk warnings so long as these are clear, fair and not misleading.

The more complex and high risk the product, the higher the threshold of required information. For example the level of detail required from a client prior to the sale of UK FTSE stocks will be less than that required prior to the sale of equities in small-cap Japanese entities. This is because the latter will involve more complex risks - foreign exchange risk and liquidity risk.

If a firm makes a personal recommendation or manages investments for a professional client in the course of MiFID business, it is entitled to assume that, in relation to the products, transactions and services for which the professional client is classified, the client has the necessary level of experience and knowledge for these purposes.

2.3. Information required for existing clients

A firm will need to obtain less information from existing clients than it would need to obtain from new clients provided that the information already held is appropriately recorded.

Firms can, therefore, adopt a flexible approach in terms of the amount of information required from existing clients which is commensurate to the nature of the client and the extent of the relationship with the client. Therefore where a client has had a long-standing relationship with the firm, the amount of new information required to test suitability may be minimal.

If a firm has tested suitability for a client previously it should be able to rely on the information provided, especially if the client's individual circumstances or the range of services offered do not require suitability to be tested afresh. From a practical perspective, firms may already have, or know, sufficient information regarding its existing clients to assess suitability. If this is not the case then the firm should carry out a suitability test.

Firms must however carry out the suitability test for all new clients when investment advisory or discretionary portfolio management services are provided. When providing an investment service, other than investment advice, a firm must also enter into a written basic agreement with all new retail clients post 1 November 2007. The agreement must set out the essential rights and obligations of the firm and the client and can be presented in paper or another durable medium.

2.4. Updating client information

The frequency of updating client information will vary from client to client depending on their individual circumstances and level of sophistication as well as the types of products for which the client receives investment advisory or discretionary portfolio management services. Firms must therefore establish the frequency with which information updates need to be obtained.

A firm may rely on information provided by its clients unless it is aware that the material is manifestly out of date, inaccurate or incomplete. However, it will still need to consider further the circumstances under which client information should be updated. Where a firm relies on a third party for information, the firm should also be able to rely on that third party to update information.

Firms are not expected to second-guess the accuracy of information or whether it is out of date. Firms are only expected to infer inaccuracy or staleness of information if it is reasonable to conclude that the information is out of date or inaccurate. For example, if a client only provides accounts or account statements that are more than five years old (or five years have elapsed since up to date accounts were provided by the client), it is reasonable to conclude that the information cannot be relied upon because it is out of date.

Similarly, if a client provides information relating to his income which seems to be contradicted by account statements provided around the same time, a firm must make further inquiries as it is reasonable to conclude that there is a discrepancy.

The updating of information will usually relate only to some elements of the information initially obtained. For example, the information as to knowledge and experience and financial situation may change in a fairly short period of time – in the case of a retail client changed employment which results in a significant increase in income is such example of this. However, it is unlikely that information as to investment objectives would need to be updated as often unless the client informs the firm that his investment objectives have changed. A case where a firm would look to update its information more regularly would be for example in the case of a discretionary portfolio management client with a high risk profile or risk appetite.

When providing services to professional clients, firms may include a provision within the account opening documentation that requires the client to update the firm whenever the client's circumstances change.

2.5. When information can be provided by other firms

A firm can rely upon any information, or any recommendation, from another firm. The firm providing the information remains responsible for the completeness and accuracy of any information about the client and the suitability test for the client in regard to any advice or recommendation provided to the client.

Whereas the receiving firm is responsible for concluding the services or transaction based on any such information or recommendation in accordance with the applicable requirements under the regulatory system.

For example where a professional firm, such as a law firm or an accountancy firm, refers a client to a firm for discretionary portfolio management services and the professional firm has suggested a certain strategy for the portfolio, it will generally be reasonable for the discretionary portfolio management firm to manage the portfolio in accordance with the instructions without being obliged to check whether the proposed strategy is suitable for the client.

2.6. When information is to be collected

Information must be obtained prior to the provision of a service. There is however no specific requirement as to <u>when</u> the information must be obtained. Information could therefore be obtained a day or a month or even a year before a service is provided. However, if information has been obtained significantly in advance of the provision of the relevant service, firms will need to consider issues relating to the updating of client information and should therefore adopt a reasonable and pragmatic approach.

2.7. Failure to obtain information

If a firm does not obtain the necessary information to assess suitability, it must not make a personal recommendation to the client or take a decision to trade for the client.

Firms should only assess the suitability of a product or service for the client after the information relating to the client has been obtained.

If a firm is unable to obtain the information necessary to test suitability, the firm should inform the client that it is not able to assess suitability and therefore is unable to recommend a product or, in the case of discretionary portfolio management, enter into a transaction.

For example a series of transactions that when viewed individually are classed as suitable for a particular client, may become unsuitable if the recommended frequency of such transactions is not in the best interests of the client. In the case of portfolio management, a transaction might also be unsuitable if it would result in an unsuitable portfolio.

A firm's inability to obtain sufficient information or where a client fails to provide all the information required would not however automatically mean that a firm must simply refuse to provide any service to the client. Where a firm is not able to obtain information sufficient to recommend a transaction, it may need to enter into discussions with the client to redefine the service. It will often be possible to provide an alternative service tailored to the level of detail of information that the client has been willing to provide and which may still meet at least some of the client's needs.

Any alternative recommendation made, or decision to trade, should be suitable.

2.8. Criteria to conclude if a transaction is suitable for a client

Having obtained the necessary information, a firm should then assess, against the background of that information, whether the specific transaction or product to be recommended, is suitable in relation to:

a) The client’s investment objectives;

b) The client’s ability to financially bear any related investment risks consistent with the investment objectives; and

c) The client’s knowledge and experience, whilst ensuring that these are sufficient for the client to be able to understand the risks involved.

Firms should satisfy themselves that the transaction recommended or entered into is likely to meet the investment objectives, although, in the context of an ongoing mandate, the firm may consider the combined effect of its investment advice overall and not just the individual transaction.

If the transaction recommended or entered into carries with it a financial risk, for example an investment that could fall in value over time or which involves the possibility of losses in excess of the amount invested, a firm should be able to demonstrate their basis for deducing such. Firms should, where relevant, assess what the impact of a reasonably foreseeable loss relating to a recommended investment would be.

Having obtained information on the knowledge and experience of the client, firms will be better placed to ensure that they have sufficient information relating to the client's understanding of the nature of risk. The provision of a risk warning to the client, provided that it is understood, may be able to supplement the existing knowledge of the client, which combined with the existing experience of the relevant client may, in some cases, result in an overall assessment that the client has sufficient knowledge and experience. In some instances a risk warning may be sufficient to ensure that the client has sufficient knowledge relating to the risk of an investment service or financial instrument.

Where a firm provides discretionary portfolio management services, a mandate will have been agreed between the firm and the client and the firm can follow this mandate unless the mandate is changed or if the client subsequently informs the firm that the information supplied is inaccurate. If the firm discovers that the information accompanying the mandate is inaccurate, the firm should consider seeking a new mandate from the client.

2.9. Personal recommendation

If a firm does not obtain the necessary information to assess suitability it cannot make a personal recommendation to the client or take a decision to trade for the client.

The key element of a personal recommendation is that the recommendation must be personal. In order for a recommendation to be personal it must be presented to the client as being suitable or based on a consideration of the personal circumstances of the client. The recommendation must include an express or implied recommendation to deal in a designated investment.

Firms will be subject to less onerous requirements when making personal recommendations to corporates that are automatically classified as professional clients, as the level of experience and knowledge and the ability to bear financial loss may be assumed. Likewise, if the service consists of making a personal recommendation to a per se professional client, the firm is entitled to assume that the client is able to bear financially any related investment risks consistent with the investment objectives of that client for these purposes.

However the same cannot be assumed for opted-up professional clients and firms must therefore obtain further information as to the client's financial circumstances, in these cases.

On this basis, advising a corporate to purchase a particular designated investment in the corporate's capacity as an investor or potential investor will be a personal recommendation.

On the other hand, providing generic recommendations or general factual information to clients, such as indicating a general preference to equities over bonds, producing league tables showing the performance of designated investments against published benchmarks or providing general debt raising and restructuring advice (i.e. advising the corporate to issue securities), will fall outside the scope of the definition.

A recommendation or request made, or advice given, by a portfolio manager to a client to the effect that the client should give or alter a mandate to the portfolio manager, that defines the limits of the portfolio manager's discretion, should be considered a recommendation.

2.10. Record keeping

A firm will need to be able to demonstrate that it has obtained the relevant information and applied the applicable tests. Records relating to MiFID business will need to be kept for five years[4].

Firms therefore need to consider their record keeping policies and procedures bearing in mind the services provided to the client, the type of clients they deal with and the documentation they normally ask for from a client when commencing a client relationship. Furthermore firms should take measures to ensure that such policies are followed in practice.

In the context of suitability, firms also need to ensure that a record of the information collected in order to establish suitability is maintained. It should not however be necessary for firms to create a separate stand-alone document recording suitability on a transaction-by-transaction basis.

3. Appropriateness

The assessment of appropriateness is less wide ranging than the suitability assessment. The appropriateness regime is concerned solely with the client´s level of understanding, thus such assessment focuses only on the relevant knowledge and experience of the client and not their financial situation or investment objectives. Here, therefore assumptions can be made in relation to the knowledge and experience of a professional client.

Appropriateness applies to firms carrying on services other than investment advice or discretionary portfolio management in the course of MiFID business.

[4] Firms should note that further obligations under other legislative provisions may require records to be kept for a longer period.

A firm is required to establish the appropriateness of a specific type of product or service before offering it to the client. In practice this means that while the client provides information initially to allow the firm to establish appropriateness, the firm should then ensure that all products and/or services offered by it are appropriate for the client on the basis of the information provided. If they are inappropriate and the client insists that the firm provide them, an appropriate warning must be given to the client. This is discussed further in Section 3.6.

The appropriateness test applies to:

- A non-advised service involving a complex product
- A non-complex product where the service is at the initiative of the firm, rather that the initiative of the client.

No appropriateness assessment is required if the service relates to "non-complex" products and is provided at the client's initiative, provided the client has been clearly informed that, in the provision of the service the firm is not required to assess the suitability of the instrument or service provided and that the client is therefore not protected by the suitability rules. In addition the firm will have also had to comply with its obligation regarding conflicts of interest[5].

If a client engages in a course of dealings involving a specific type of product or service through the services of a firm, the firm is not required to make a new assessment on the occasion of each separate transaction. Furthermore by classifying certain product types as "appropriate" to a particular client at the outset each new product will not require appropriateness to be re-tested. A firm will have complied with the requirement provided that it makes the necessary appropriateness assessment before beginning that service.

A firm need not test appropriateness if it is receiving or transmitting an order in relation to which it has already tested suitability.

3.1. Obtaining information

When collecting information a firm should seek enough information in relation to the client or potential client, regarding their knowledge and experience in the investment field, in relation to the product or investment service demanded or offered. This is necessary in order to later establish, on the basis of this information, whether the client has the necessary knowledge and experience to understand the risks involved in relation to the product or investment service demanded or offered. This ultimately allows the firm to assess whether the service or product envisaged is appropriate for the client.

Firms can decide for themselves how they seek the necessary information from clients. Depending on the type of service and the complexity of the product, firms could require clients to complete a standardised questionnaire, a tailored questionnaire or a combination of both. Alternatively, firms could simply ask a short set of targeted questions to test a client's knowledge of the principal risks associated with a product or service. This information may be obtained in a meeting with the client, or a telephone conversation or other means of communication such as e-mail interchange subject to these being properly recorded and documented.

[5] This is discussed further in Managing Conflicts of Interest and related Organisational Requirements guidance note.

3.2. Level of detail of information

When determining the level of detail of information to seek from clients, a firm should assess:

- The types of service, transaction and financial instrument with which the client is familiar
- The nature, volume, and frequency of the client's transactions in financial instruments and the period over which they have been carried out
- The level of education, and profession or relevant former profession of the client or potential client.

The above information is to be collated, to the extent appropriate, considering the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including its complexity and the risks involved.

The information required is the same to that required when assessing the knowledge and experience of a client when performing the suitability test. As outlined in Section 2.2.3.

A firm is permitted to assume that a professional client has the necessary knowledge and experience in order to understand the risks involved in relation to those products, transactions and services for which it is classified as a professional client. When dealing with corporate customers, who are classified as retail clients, the level of knowledge and experience within the corporate entity can also be assessed either on the basis of the past investment history of the corporate client or alternatively on the basis of the knowledge and experience of the people in that corporate with whom the firm deals on a regular basis and to whom any recommendations are to be made. The firm can also take into account the knowledge and experience of individuals authorised to make investment decisions on behalf of the corporate as a whole. As a result, a firm may also combine together the past investing experience of the corporate with the knowledge and experience of individuals within the corporate with whom it deals, to determine the overall level of knowledge and experience of the corporate.

The level of detail can be graded by the complexity of the instrument and depending on the degree of the non-complex criteria that are satisfied, differing standards of diligence (high, intermediate and low) should be applied. For example, it is likely that less information will be required for a straight-forward and low risk product than for a more complicated or higher risk product.

Similarly, the intensity of the appropriateness test required may differ between a complex product offered to a very experienced and knowledgeable client and the same product offered to an inexperienced client with little product knowledge.

3.3. Existing information

In assessing appropriateness, a firm can use information it already has in its possession unless it is aware that the information is manifestly out of date, inaccurate or incomplete. It may be the case that the firm simply has to ensure that this information is appropriately recorded.

A firm may need to seek less information from existing clients than it would need to obtain from new clients provided that the firm has a record of the relevant information already received. Firms can, therefore, adopt a flexible approach in terms of the amount of information required from clients depending upon the nature of the client and the extent of the relationship with the client. Where a client has had a long-standing relationship with the firm, the amount of new information required to test appropriateness may be minimal.

Furthermore a firm can presume that a client who has engaged in a course of dealings involving a specific type of product or service before 1 November 2007 has the necessary experience and knowledge in order to understand the risks involved in relation to that product or investment service. This equates to a form of grandfathering for such clients and a suitable note of this fact will suffice for record keeping purposes.

3.4. When information can be provided from other firms

A firm, in certain cases, will be permitted to rely completely on information provided by a third party, with the same conditions to be applied as discussed in Section 2.5 in regards to the suitability test.

Hence a firm may rely on any recommendations in respect of the service or transaction that have been provided to the client by another firm. Furthermore in circumstances where firms receive an instruction to perform investment or ancillary services on behalf of a client through the medium of another firm, it is the responsibility of the firm which mediates the instruction to ensure appropriateness of the recommendations or advice provided to the client.

Even where the above does not apply, a firm may obtain the required information from a third party provided that it can demonstrate that it was reasonable for the firm to do so.

3.5. When an appropriateness test is not required

When providing investment services that only consist of execution or the reception and transmission of client orders with or without ancillary services, firms may provide those services to their clients without the need to first obtain the information or make the determination of appropriateness if all of the below is met:

- The investment services relate to shares admitted to trading on a regulated market or in an equivalent third country market[6], money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments.
- The service is provided at the initiative of the client or potential client.

  A financial promotion which is aimed at the general public would not be considered a personalised communication and, therefore, an approach made by the client in response to such a promotion would be characterised as an approach that is at the initiative of the client. A service would be deemed as not to have been provided at the initiative of the client if the client approaches a firm following a personalised communication to the client by the firm.

[6] A third country market shall be considered as equivalent to a regulated market where the Authority is of the opinion that it complies with equivalent requirements to those established under Part III of the Financial Services (Markets in Financial Instruments) Act 2006.

- The client or potential client has been clearly informed by the firm that in the provision of this service the firm is not required to assess the suitability of the instrument or service provided or offered and that therefore the client does not benefit from the corresponding protection of the Regulations[7];
- The firm complies with its obligation in regards to Conflicts of Interest requirements[8].

Certain types of clients are also exempt from the appropriateness test - for example, professional clients and certain eligible counterparties. As previously discussed in Section 3.2, a firm is entitled to assume that a professional client has the necessary experience and knowledge to understand the risks involved in relation to the investment service and transaction for which that client has been classified as a professional client. Furthermore business falling within the eligible counterparty regime, relevant to the reception and transmission of orders, the execution of orders on behalf of clients and dealing on own account, are also exempt from the test.

3.6. Issuance of warnings

If a firm considers that it is unable to assess appropriateness due to one or more of the following reasons:

a) on the basis of the information received;

b) where a client has elected not to provide information, or

c) where the client provides insufficient information regarding his knowledge and experience,

then that firm must warn the client that it will not be able to determine whether the service or product envisaged is appropriate for the client. This warning may be provided in a standardised format.

If a firm provides a warning and the client asks the firm to proceed with the transaction, the firm should consider whether it would be in the client's best interests to proceed with the transaction.

3.7. Timeframe for collecting information

There is no specific requirement as to when the information must be sought however this must be done prior to the provision of a service.

The information could be sought a day or a month or even a year before a service is provided. However, if information has been obtained significantly in advance of the provision of the relevant service, firms will need to consider issues relating to updating of client information and should therefore adopt a reasonable and pragmatic approach.

A firm may rely on the information provided by its clients, unless it is aware that the information is manifestly inaccurate, out of date or incomplete.

[7] Can be accessed via http://www.gibraltarlaws.gov.gi/articles/2007s120.pdf.

[8] As per Section 18 of the Act.

3.8. Record Keeping

A firm must maintain a record of the client information obtained and each appropriateness assessment it makes as it will need to be able to demonstrate that it has obtained the relevant information and applied the applicable tests.

A firm's records must include the document or documents agreed between the firm and the client that set out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client.

Furthermore firms should have record keeping policies and procedures in place considering the services provided to the client, the type of clients they deal with and the documentation they normally ask for from a client when commencing a client relationship.

Such policies and procedures should be monitored and a firm should take measures to ensure that they are followed given that the requirement for retaining records equates to a minimum of five years.

4. Best Execution

4.1. Application of the Best Execution

A firm is not expected to expend disproportionate amounts of funds or resources, leading to heavy overall increase of fees, on achieving best execution.

Resources and funds committed should be reasonable and proportionate to the firm's resources, but should nonetheless aim to produce the best result the firm is able to obtain for the client.

The standard is set at the best possible result that a firm can reasonably be expected to achieve for its clients, rather than as an absolute standard that must be achieved by the firm, irrespective of the resources available to it. This will vary depending on: the type of firm – its size and the capacity in which it acts; the nature of the client; and the type of product and the available market for that product.

Whether the execution of an order provides the best possible result should be assessed at the time of execution. The best possible result should also be achieved on a consistent basis when executing client orders in respect of a particular product type on a selected venue.

When considering the best execution requirements the following points should be considered:

- Whether the transaction involves a financial instrument
- The type of client involved
- Whether the transaction involves the execution of a client order
- Whether execution of the client order is determined by specific instructions.

The criterion for assessing best execution needs to be tailored to the particular characteristics of each market. This should not, however, be interpreted as applying best execution in a way that is appropriate to a particular market or product, without the presence of a precise or reliable benchmark.

Whenever there is a specific instruction from the client the firm must execute the order following the specific instruction, by doing so the firm is deemed to have complied with the best execution requirement to the extent of that instruction.

4.2. Factors

When executing orders, firms must take all reasonable steps to obtain the best possible result for their client taking into account the following factors: price; cost; speed; likelihood of execution and settlement; size of the order; nature of the order; or any other consideration relevant to the execution of the order.

The relative importance of the factors referred to above should be considered in respect of:

- Clients – the client categorisation, factors relevant to the relationship including frequency of trading and the provision of any value added services that are linked to the execution of the transaction.

  For example, a professional client may consider that fast matching at large volume is key to ensuring execution at a particular market. Whereas for smaller clients, cost may be a more important overall factor.

- Orders – the size of the order, types of instruments traded, the settlement mechanics and any other characteristics relevant to determining how client orders should be executed.
- Instruments – the degree of liquidity and consideration of relevance of different factors to different instruments depending on their nature, characteristics and how they are traded.
- Market impact – the impact the client order may have on the relevant market/s.
- Quality of execution – the speed and likelihood of execution as well as the availability and incidence of price improvement.
- Execution venue – the price offered by the venue, the amount of any commissions and any other charges that are passed through to the client, the ability of the venue to manage complex orders, including the sophistication of its systems, the speed of execution, the creditworthiness of the venue, whether it has reliable settlement and clearing facilities, the quality of applicable regulation and any other venue characteristics relevant to the execution of the order.

  The fact that a firm may be able to trade on a venue within a European time zone may prove a significant contributing factor. For example, in the context of dual listed securities, the speed of execution may be a more important factor than price.

Consideration of the above factors means that a firm should consider the nature of the execution services that it provides and the way in which it provides them.

Responsibility for assessing the relative importance of the factors lies with the firm. However where the 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 instruments and the costs related to execution. This shall include all expenses incurred by the client which are directly related to the execution of the order.

Speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs may be given precedence over the immediate price and cost factors only insofar as they are instrumental in delivering the best possible result in terms of total consideration to the retail client.

Total consideration is paramount in the case of orders from retail clients, however, treatment of professional clients is different as firms are fully responsible for determining the weight they attribute to execution factors in their execution arrangements and policies in the case of orders from professional clients.

It is generally considered that in most circumstances, price and cost will merit a high relative importance in obtaining the best possible result for professional clients, although there will always be certain circumstances where other factors will be more important.

The concept of best result is likely to vary between firms depending on the prioritisation of the factors mentioned above, which the FSC will require firms to establish and implement effective arrangements for complying with such.

4.3. Execution Policy

A firm is required to document the process and procedures it applies to client orders in order to obtain the best possible result in accordance with the factors discussed in the previous section.

These requirements are intended to ensure that the firm has a comprehensive approach to meeting the requirement to take all reasonable steps to obtain the best possible result for its client orders and to ensure that a firm has control over its execution practices and procedures. This will also help to ensure that the firm's execution practices and procedures are understood both by the relevant persons within the firm, including compliance staff, and by the FSC. This should also be sufficient to enable the client to make a properly informed decision about whether to utilise the execution services offered by the firm.

As mentioned previously there are differences in the requirements that apply to firms executing orders to those firms that receive and transmit client orders or place orders with entities for execution in the course of managing portfolios for clients.

Firms that execute client orders must:

- Put in place arrangements including an execution policy so as to take all reasonable steps to obtain the best possible result for the execution of their client orders.
- Obtain client consent to the execution policy.
- Be able to demonstrate on a client's request that they have executed that client's order in compliance with their execution policy.

The execution policy will need to form part of the firm's overall execution arrangements.

Firms that receive and transmit client orders, or place orders with entities for execution in the course of managing portfolios for clients, must implement a policy to achieve the best possible result for client orders.

All firms must also:

- Disclose appropriate information to clients about the firm's execution policy;
- Monitor their compliance with the execution approach and correct deficiencies;
- Monitor whether their execution approach is allowing them to obtain the best possible results for clients and if not, correct deficiencies; and
- Review their execution policy approach as a whole and the execution venues or entities they use on a regular basis, whenever a material change occurs and at least annually, to ascertain whether the approach is delivering the best possible results for the execution of client orders.

How the policy is presented is at the firm's discretion - one single policy with separate parts or as individual policies for each type of product/client. Either way it must be clear which policy or section applies to each type of product or client and must likewise be applied properly and appropriately to each client order.

4.4. What a firm should consider when establishing a policy

When establishing its execution policy, a firm should determine the relative importance of the execution factors, so that it can deliver the best possible result to its clients.

The following areas can be explored when initially preparing an execution policy, and are discussed further in the next section:

- Which transactions best execution applies to.
- Whether the execution of an order is outside of a regulated market or multi-lateral trading facility and the need to obtain the clients written consent to do so.
- Whether the policy allows for all the relevant consideration to be accounted for assessing the factors that should be given priority for clients.
- What the firm's position in the execution chain is.
- Inclusion of an analysis of execution venues in order to identify those firms that will enable you to obtain the best possible result.
- Processes for routing client orders to the appropriate venues.
- Review of the execution policy – which should be at least annually, or in the event of a material change.
- Disclosing the execution policy to clients and other information that may be required to be issued to clients.
- A clear warning, in a prominent place, stating that any specific instructions from a client may prevent the firm from taking steps designed in the execution policy to obtain the best possible result.
- Systems for recording details of the policy and any relevant correspondence with clients and considering the five year minimum retention period.

4.5. Content of the Execution Policy

All firms must describe and explain the firm's execution approach in their execution policy in order to obtain the best possible result for the relevant categories of instruments, orders, clients and markets that it deals with. Additionally it should also set out the execution venues or entities the firm uses.

The main areas that the execution policy must address are:

- The firm's execution approach for carrying out orders (including executing, placing an order and receiving or transmitting a client order) for execution, from the time that an order originates to the time that it is executed or settled, as the case may be.
- The execution venues or entities the firm uses and the role of execution quality and any other factors in selecting them.
- The different factors influencing the firm's execution approach for carrying out client orders.
- Why the firm's execution approach for carrying out client orders will deliver the best possible result for the execution of those client orders.

A firm does not need to publish its model for pricing contracts or any commercially confidential or sensitive data relevant to that model. Furthermore, a firm is not required to publish the dealing volume or methodology of the firm as part of its policy or to obtain the detail of equivalent models from other competitor firms as part of its exercise to satisfy itself that its model is competitive. However, a firm should disclose the factors and criteria that are used by it in order to determine how it satisfies itself that it, or any model used by it, is properly assessed for the purposes of obtaining best execution for clients.

4.6. Execution venue

The execution policy shall include in respect of each class of instruments, information on the different execution venues where the firm executes its client orders. It must at least include those venues that enable the firm to obtain on a consistent basis the best possible result for the execution of client orders. The firm should assess on a regular basis whether the venues continue to provide the best result.

The obligation to take all reasonable steps to obtain the best possible result for the client should not be treated as requiring a firm to include in its execution policy all available execution venues.

In the case of firms that receive and transmit client orders or place orders with entities for execution in the course of managing portfolios for clients, such firms must include the entities that the firm uses for the execution of its client orders in respect of each class of instruments in respect of achieving the best possible result.

When selecting venues to be included in its execution policy a firm should not take into account the fees and commissions that it will charge its clients. Firms are free to set their fees or commissions at whatever level they choose, provided that no venue is unfairly discriminated against.

Firms are not permitted to structure or charge their commission in such a way as to unfairly discriminate between execution venues. A firm cannot charge a different fee for execution on different venues unless the difference reflects a difference in the cost to the firm, nor is it able to direct all its orders to an affiliated firm within its corporate group on the basis that it charges its clients a much higher fee for access to other venues that is unwarranted by higher access costs, nor is it able to refrain from connecting to any of the venues included in its execution policy in the least costly manner.

Varying costs to be borne by the client according to the competing venue chosen, where they exist, should be taken into account so that the client pays the lowest possible net cost, or receives the highest possible net proceeds. A firm would need to take into account not only prices displayed by two venues but also any difference in fees or commission it charges the client for executing on one venue rather than on the other. A firm should focus on the potential of the venues to enable it to deliver the best possible result to its clients on a consistent basis, concentrating on the quality of execution available at various venues.

The disclosure requirements regarding a firm's fees and commission ensure that investors are able to distinguish the price of the instrument on a particular venue from the fee or commission charged by the firm for access to that venue.

A firm may include only one execution venue in respect of a particular product provided that the firm has taken all reasonable steps to identify other venues. This would have to be justified by reference to the overarching requirement to take all reasonable steps to obtain the best result. Whenever there is more than one trading venue that offers execution relevant services firms should consider their inclusion in its execution policy.

In order to indicate venues that the firm places significant reliance on, a firm needs to identify its most used venues. The information to be provided to clients can take the form of generic information on the venues used. Firms can specify that the execution venues provided in the policy are not exhaustive and that execution may occur at alternative venues from time to time provided those venues are consistent with the policy.

A firm that executes client orders is not obliged to examine the execution arrangements of its execution venues. However, a firm that executes client orders is required to use execution venues that are likely to achieve the best possible result on a consistent basis.

Firms that receive and transmit client orders or place orders with entities for execution in the course of managing portfolios for clients, are required to use entities whose execution arrangement will enable them to comply with its own obligation and are additionally required to monitor the execution quality of those entities on a regular basis. Other monitoring requirements are discussed in Section 4.8.

In particular, all firms 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.

4.7. Informing clients

Information requirements are intended to encourage clients and potential clients to review certain key information about a firm's execution arrangements, which takes the form of the execution policy. This enables clients to compare execution services from different firms and select the one that best suits their needs based on differences in their execution strategies, objectives or processes.

Information provided to clients must be appropriate and proportionate and take account of the status of a client, and reflect any significant variations in the execution approach for each class of instrument. Disclosure of the execution policy is only required insofar as it will be relevant for the client and the types of orders that the client may send to the firm. For example, a typical retail client will not require information on how the firm executes trades in instruments that are seldom purchased by retail clients, this therefore avoids clients being bombarded with irrelevant information.

There is no equivalent provision relating to what appropriate information must be provided to professional clients as it is expected that professional clients should, subject to limited exceptions, be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the firm to provide that information. In essence it is up to the firm to determine what level of information disclosure is appropriate for professional clients, through appropriate consultation with such clients if necessary.

For firms executing client orders it is a requirement that retail clients be provided with the following details of the firm's executing policy prior to the provision of the service:

- The relative importance the firm assigns to the factors listed in Section 4.2, or the process by which it determines the relative importance;
- A list of the execution venues on which the firm places significant reliance in meeting its best execution obligations;
- A warning to the client regarding the use of specific instructions.

Information should be provided in a durable medium. Other information that may be disclosed by the firm is not subject to these disclosure requirements. Where the retail client agreement is required, as discussed in Section 2.3, such disclosure can be incorporated into the agreement.

Firms are to also provide additional post-information rights as they must demonstrate, at the client's request, that the order has been executed in accordance with the firm's execution policy. This requirement assists clients in assessing whether the service received from a particular firm is satisfactory and further reinforces the investor protection objective by requiring firms to demonstrate compliance with their execution policy.

Firms such as portfolio managers and firms that receive and transmit orders to third parties, are required to disclose appropriate information about their policy to clients, however, there is no requirement for the firm to demonstrate compliance in the manner detailed above.

Further information <u>may</u> be requested by clients. However, a firm is not specifically required to provide further information under the requirements.

Where there are any information requests of this type, firms should endeavour to supply this additional information, provided the request is reasonable and proportionate.

4.7.1. When consent is required

A firm executing orders has to obtain the consent of its clients to its execution policy. Firms therefore need to ensure that their execution policy disclosure is sufficient for consent to be valid. Firms may choose to include the additional information required for retail clients in their policies.

Where prior consent is required this may be provided by signature in writing or via an equivalent means – for example, electronic signature, via a web page, clicking an acceptance button, or orally by telephone or in person, with appropriate record keeping in each case. A firm may be asked to show that it has supplied clients with the appropriate information on its execution policy.

Where the policy provides for the possibility that client orders may be executed outside a regulated market or an MTF the firm is to inform its clients about this possibility and the firm must first obtain prior express consent from clients before proceeding to execute such orders. Consent can be sought in the form of a general agreement or in respect of individual transactions.

For firms such as portfolio managers and firms that receive and transmit orders to third parties there are no requirements in regard to obtaining client consent to their execution arrangements.

4.8. Monitoring and reviewing the Execution Policy

A firm should monitor the effectiveness of its execution arrangements and policy through assessing the execution venues in its execution policy and conducting a review on a regular basis.

The review is an important driver of market efficiency as it requires that firms put procedures in place to ensure that execution business is directed to the most appropriate execution venues. Firms should also review their approach generally to see whether they could usefully make any changes to improve overall performance. More specifically, firms should consider whether the relative importance they have assigned to these factors has led them to deliver the best possible result for their clients or whether they should reconsider this aspect of their execution approach.

The requirements set out that firms must:

- Monitor the effectiveness of their order execution arrangements and execution policy.
- Notify clients of any material changes to their order execution arrangements or execution policy.
- Demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy.

The monitoring requirement relates to the effectiveness of a firm's current approach in delivering the best possible result for its client orders, including the execution quality being delivered by the venues currently included in the execution policy.

Where deficiencies are identified, a firm must act to correct them. The two areas a firm may need to monitor to establish effectiveness of its execution policy and arrangements are:

1. Compliance with the execution approach to ensure that it is following its execution approach; and
2. Whether a firm is actually obtaining the best possible result under the execution policy – for example this can be tested by comparing similar transactions on the same venue or on different venues.

   This could be undertaken by a carrying out a sample test, however this must reflect the size and nature of the transactions performed and the firm must appropriately assess and compare the relevant available data.

All firms must in addition monitor the impact of their own actions on the execution quality they achieve.

Portfolio managers and firms that receive and transmit orders to third parties must monitor the execution quality of the entities they select for their policies, to ensure that these are delivering the best possible result under the current policy. If the firm's policy includes other firms as well as direct access to markets and/or firms dealing on own account then these would need to be reviewed relative to one another as part of the review process.

The monitoring and review requirements mean that portfolio managers and firms that receive and transmit orders to third parties also need to assess their own execution quality. Information on execution quality is essential. Data availability of this is likely increase as a result of MiFID implementation and this should assist firms in meeting their review and monitoring obligations. This information could include aspects such as speed and likelihood of execution, fill rate, and the availability and incidence of price improvement.

A firm may decide how frequently it will review its policy, and this may vary depending on the product type. For example, liquid equities with numerous venues should be reviewed more frequently than illiquid securities on a single execution venue.

There is, however, a set minimum as a review is to be carried out at least annually as well as whenever the firm is made aware that a material change has occurred.

What is classed as material will depend to a large extent on the nature and scope of any change. A material change may relate to a change to one of the factors affecting execution or an execution venue itself. Some examples include: where it is no longer possible, due to closure or other reason beyond the control of the firm, for a firm to execute orders through a venue on which it places significant reliance and there is no alternative venue available on which the execution of orders may be effected; a firm using one venue might have to review its approach if a major new venue entered the relevant market, whereas alternatively a firm using various execution intermediaries would not have to review its approach just because of the entrance of an insignificant new market participant.

When reviewing its policy, a firm should take into account any changes to the factors affecting execution that have occurred since the last review and conduct an analysis of the venues, to ensure that those venues identified in the policy continue to meet the relevant requirements.

If following a review, a firm identifies that the venues included in the policy do not provide for the best possible result, it must take steps to amend its policy.

4.9. When services are provided by other firms

Where different firms have different functions in a chain of execution best execution requirements should be applied as necessary to take account of the particular function performed by each firm in the chain. There is no requirement for firms to adopt the same measures, as those of others in the chain, to provide best execution.

Firms using the services of another in the chain of execution need to take all reasonable steps to select entities that are most likely to deliver the best possible result. Any intermediaries used however must comply with the requirements applicable for firms executing orders. Intermediaries or venues not subject to MiFID's best execution requirements can be used, however, the firm must satisfy itself that those intermediaries have execution arrangements, or standards of execution quality that will allow it to comply with the relevant requirements. If it is not able to do this then the intermediaries or venues cannot be used.

A firm would also need to monitor the execution quality delivered by the firm whose services it was using and take the necessary steps to correct any deficiencies when these arise. Provided that this is carried out, the firm should be entitled to rely on the ability of the firm providing the services to deliver best execution.

Where in the chain of execution a firm is treated as an eligible counterparty, a duty of best execution is not owed. It must nevertheless ensure that any entities with which orders are placed, or to which the firms transmits order for execution, have execution arrangements that enable the firm to comply with the relevant requirements. This is a similar case with portfolio managers or firms that receive and transmit orders to third parties who wish to specify aspects of the execution service, for example choice of execution venue, as this could be regarded as a specific instruction and therefore such firms are not, for this aspect of the execution, able to rely on the provider ensuring best execution.

In the case of overlapping of responsibilities, a firm should determine whether best execution obligations are owed. It is not intended, however, that there be a duplication of effort between a firm, which provides the service of order reception and transmission or portfolio management, and any firm to which the firm transmits its orders for execution.

4.10. Record keeping

In order to demonstrate to clients, at their request, that a firm has executed orders in accordance with the policy, it must maintain adequate records of all client orders and ensure that such records reflect that the orders were executed in accordance with the policy in place at the time. A firm needs to consider the storing of documents, such as the record of consent provided by clients, and its document retention policy and any revisions or changes to this.

Records are to be kept for a minimum of five[9] years.

[9] Firms should note that further obligations under other legislative provisions may require records to be kept for a longer period.