Questions and Answers

On MiFID II and MiFIR investor protection topics

10 October 2016 | ESMA/2016/1444

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Acronyms and definitions used

ESMA	The European Markets and Securities Authority
ITS	Implementing Technical Standards
MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and of the Council
MiFID II	Markets in Financial Instruments Directive (recast) – Directive 2014/65/EU of the European Parliament and of the Council
MiFIR	Markets in Financial Instruments Regulation – Regulation 600/2014 of the European Parliament and of the Council
MTF	Multilateral Trading Facility
OTC	Over The Counter
OTF	Organised Trading Facility
Q&A	Question and Answer
RPA	Research Payment Account
RTS	Regulatory Technical Standards

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	3	Monitoring of records	Art.16(7) of MiFID II Art. 76(6) of the MiFID II Delegated Regulation	10/10/2016
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Introduction

Background

The final legislative texts of Directive 2014/65/EU[1] (MiFID II) and Regulation (EU) No 600/2014[2] (MiFIR) were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. The two texts were published in the Official Journal on 12 June 2014 and entered into force on the twentieth day following this publication – i.e. 2 July 2014.

Many of the obligations under MiFID II and MiFIR were further specified in the Commission Delegated Directive[3] and two Commission Delegated Regulations[4] [5], as well as regulatory and implementing technical standards developed by the European Securities and Markets Authority (ESMA).

MiFID II and MiFIR, together with the Commission delegated acts as well as regulatory and implementing technical standards will be applicable from 3 January 2018.

Purpose

The purpose of this document is to promote common supervisory approaches and practices in the application of MiFID II and MiFIR in relation to investor protection topics. It provides responses to questions posed by the general public, market participants and competent authorities in relation to the practical application of MiFID II and MiFIR.

The content of this document is aimed at competent authorities and firms by providing clarity on the application of the MiFID II and MiFIR requirements.

The content of this document is not exhaustive and it does not constitute new policy.

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[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

[2] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) N0 648/2012.

[3] Commission Delegated Directive 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. The Commission Delegated Directive was published on 7 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

[4] Commission Delegated Regulation 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. The Commission Delegated Regulation was published on 25 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

[5] Commission Delegated Regulation of 18.5.2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions. The Commission Delegated Regulation was published on 18 May 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 50 of MiFIR.

Status

The question and answer (Q&A) mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation[6].

Due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if Q&As are not formally consulted on, ESMA may check them with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group or, where specific expertise is needed, with other external parties.

ESMA will periodically review these Q&As on a regular basis to update them where required and to identify if, in a certain area, there is a need to convert some of the material into ESMA Guidelines and recommendations. In such cases, the procedures foreseen under Article 16 of the ESMA Regulation will be followed.

Questions and answers

This document is intended to be continually edited and updated as and when new questions are received. The date on which each section was last amended is included for ease of reference.

[6] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a Europe-an Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.

1 Best execution [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

How should firms and competent authorities understand the difference between "reasonable steps" and "sufficient steps"?

Answer 1

MiFID I required firms to "*take all reasonable 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*". MiFID II now instead requires firms to "*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*".

Whilst firms remain subject to the same overarching obligation to obtain the best possible results on a consistent basis when executing client orders, the requirement for "sufficient" steps sets a higher bar for compliance than "reasonable" steps.

When designing their execution policies and establishing their execution arrangements, firms will have to ensure that the intended outcomes can be successfully achieved on an on-going basis. This is likely to involve the strengthening of front-office accountability and systems and controls according to which firms will ensure that their detection capabilities are able to identify any potential deficiencies. This will require firms to monitor not only the execution quality obtained but also the quality and appropriateness of their execution arrangements and policies on an ex-ante and ex-post basis to identify circumstances under which changes may be appropriate. An example of ex-ante monitoring would be to ensure that the design and review process of policies is appropriate and takes into account new services or products offered by the firms. Accordingly, an ex-post monitoring may be to check whether the firm has correctly applied its execution policy and if client instructions and preferences are effectively passed along the entire execution chain when using smart orders routers or any other means of execution.

Firms' processes might involve some combination of front office and compliance monitoring and could use systems that rely on random sampling or exception reporting.

There should be channels in place to ensure that the results of ongoing execution monitoring are escalated to senior management and/or relevant committees, and fed back into execution policies and arrangements to drive improvements in the firm's processes.

This overarching requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion. Rather, firms will need to verify on an on-going basis that their execution arrangements work well throughout the different stages of the order execution process. ESMA expects firms to take all appropriate remedial actions if any deficiencies are detected so that they can properly demonstrate that they have taken "all sufficient steps" to achieve the best possible results for their clients.

Question 2 [Last update: 10 October 2016]

What is meant by checking the fairness of the price proposed to the client when executing orders or decisions to deal in OTC products?

Answer 2

MiFID II strengthens the existing best execution standard in relation to OTC[7] products. In this regard, Article 64 of the MiFID II Delegated Regulation requires firms to check the fairness of the price proposed to the client when executing orders or taking decisions to deal in OTC products, including bespoke products, by gathering market data used in the estimation of the price of such products and, where possible, by comparing with similar or comparable products.

Firms, as a matter of practice, may be routinely taking account of external market data and externally verifiable reference prices (where available), when pricing or checking the price of OTC products (including bespoke instruments), in fulfilling their best execution obligations. However, MiFID II now imposes an explicit requirement on firms to ensure that such checks are undertaken on a systematic basis and embedded in their policies and practices. As a consequence, firms need to ensure that they have the necessary procedures and arrangements in place as well as appropriate valuation systems. With greater access to technology and data analytics, firms will be expected to scrutinise the methodologies and inputs underpinning any valuation processes and pricing models utilised with respect to OTC products in order to ensure that they are consistently checking the fairness of the price. Similarly, when placing orders resulting from decisions to deal in OTC products, firms will be expected to undertake the necessary checks on the fairness of the price and ensure that it is reflected in their arrangements.

This is an ex-ante assessment by the firm that takes place prior to the execution of the order. However, there is an expectation that any pre-trade checks or processes would be included in the firm's review and monitoring of its best execution arrangements. Firms would therefore need to have records, documentation in place, to evidence this as part of their ongoing monitoring of best execution.

[7] For the purposes of this Q&A, a financial instrument is an Over The Counter or OTC product when it is: (i) not admitted to trading, or, (ii) not traded on a trading venue (i.e. a regulated market, an MTF or OTF).

The aim is for firms to be able to justify their pricing decisions, and have systems in place to ensure that any judgements or decisions are taken with the clients' best interests in mind and are not biased by conflicts of interest.

We expect that any checks or controls will be calibrated according to the nature of the financial instrument and the characteristics and circumstances of the individual trade.

2 Suitability and appropriateness [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Does the suitability report only have to be provided if the investment advice leads to a transaction?

Answer 1

No. A suitability report must be provided to a retail client when that client has been provided with investment advice, regardless of whether or not the advice is followed by a transaction.

According to the second subparagraph of Article 25(6) of MiFID II, the firm shall, when providing investment advice, 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.

Article 54(12) of the MiFID II Delegated Regulation states that firms shall provide a suitability report when providing investment advice. The report shall, *inter alia*, include an outline of the advice given and how the recommendation is suitable for the retail client.

By outlining that the report shall be given when providing investment advice, the implementing measures clarify that the suitability report has to be provided to the client irrespective of whether or not the advice is followed by a transaction. In fact, investment advice, as defined in Article 4(2)(4) of MiFID II does not require a recommendation to be followed by a transaction.

The wording in MiFID “before the transaction is made”, is therefore a clarification of when the report has to be provided, but does not mean that the advice has to be followed by a transaction.

This is line with the purpose of the second subparagraph of Article 25(6) of MiFID II that states that the suitability report serves the purpose of proving whether the recommendation given was in fact suitable for the client.

Question 2 [Last update: 10 October 2016]

Shall the suitability report contain the record of when the investment advice is given to the client?

Answer 2

Yes. The suitability report should contain the date and time of the day when the advice was given to the client. Firms should also keep a record of the date and time when the suitability report was provided to the client (if these dates differ, as may be the case when the interaction with the client occurs through a means of distance communication).

Finally, firms must keep the respective suitability report according to MiFID II record keeping requirements.

To fulfil these reporting and documentation requirements, it may be useful to timestamp the suitability reports. However, if firms comply with the above in any other way, a timestamp may not be necessary.

Question 3 [Last update: 10 October 2016]

Can the suitability report be made available to the client on the firm's website, with the client receiving a notification (via email or through any other means of communication) regarding the availability of this document?

Answer 3

Yes. According to Article 25(6) MiFID II, the suitability report has to be provided in a durable medium. In this regard, Recital 82 of MiFID II clarifies that a durable medium may also be in an electronic form. Websites and other media in electronic form are therefore not excluded so long as they fulfil the definition of 'durable medium' as set out in Article 4(1) point 62 of MiFID II and the requirements set out in Article 3 of the MiFID II Delegated Regulation.

Therefore, the suitability report can be made available to the client in a secured area of the firm's website, specifically dedicated to that client, with the client receiving a notification (via e-mail or through any other means of communication) of the availability of the document on the website, provided that the choice of that medium is compliant with MiFID II relevant requirements. In particular, it should be consistent with the type of interaction with the client (for example, if the interaction occurs through the telephone or another means of distance communication) and the client has to give his/her consent.

Question 4 [Last update: 10 October 2016]

Can the suitability report be sent together with the report due when carrying out an order on behalf of a client other than for portfolio management?

Answer 4

According to Article 25(6) MiFID II, the suitability report has to be provided to the client before the transaction is made. Therefore, it cannot be sent together with the report that is due when carrying out an order on behalf of a client, which has to be provided after the order was carried out.

Different requirements apply in situations described in the third subparagraph of Article 25(6) of MiFID II (i.e. when the agreement is concluded using a means of distance communication)

In these cases the suitability report could be sent together with the report about the transaction, but without undue delay and all the relevant requirements have to be fulfilled.

Question 5 [Last update: 10 October 2016]

Shall a suitability report be provided to the client when the advice given is not to buy or sell a financial instrument?

Answer 5

Yes. Firms providing investment advice are required to always provide the client with a suitability report, irrespective of the specific recommendation given, including the advice not to buy, hold or sell a financial instrument.

In this regard, Recital 87 of the MiFID II Delegated Regulation specifically clarifies that *"investment firms should undertake a suitability assessment not only in relation to* [when] *recommendations to buy a financial instrument are made but for all decisions whether to trade including whether or not to buy, hold or sell an investment"*.

Question 6 [Last update: 10 October 2016]

What are the obligations on a firm when a specific financial instrument is unsuitable for a client, in particular also in situations when the client wishes to proceed with the transaction nonetheless?

Answer 6

When providing investment advice, firms are required under Article 25(2) of MiFID II to recommend to the client (or potential client) only the investment services and financial instruments that are suitable for him/her and, in particular, are in accordance with his risk tolerance and ability to bear losses. Recital 87 of the MiFID II Delegated Regulation clarifies that a suitability assessment should be undertaken "*not only in relation to* [when] *recommendations to buy a financial instrument are made but for all decisions whether to trade including whether or not to buy, hold or sell an investment"*.

Therefore, firms should avoid any behaviour that might result in a breach of the rules on suitability. Examples of clearly incorrect behaviours (see, for example, Case 1 and Case 2 below) could be situations where the purchase of a specific financial instrument cannot be recommended to a client because that instrument is unsuitable for him and the firm influences that client to proceed with the transaction at his/her own initiative (for instance, by emphasising only the positive aspects of the product); or where the firm purposely changes the client's profile (without there being any real change in the client's situation that would justify such a modification of the profile) in order to make suitable a financial instrument that is unsuitable for him/her, so as to be able to recommend it.

CASE 1: Client A has an ongoing relationship with Firm X for the provision of investment services, including investment advice. Firm X has a contractual relationship with a third party (e.g. Company Z) for selling products issued by Company Z itself.

Client A would like to make an investment and, in the context of his relationship with Firm X, asks for an advice from the firm. The firm, knowing that an investment in products issued by Company Z would be unsuitable for client B, deliberately raises his profile (although no changes in the clients' situation, that would justify such a change, have effectively occurred), so as to be able to recommend them.

CASE 2: Client B has an ongoing relationship with Firm Y for the provision of investment services, including investment advice. Firm Y is also the issuer of product Y and has a specific interest in placing it in order to meet its funding needs.

In the context of the relationship with client B, the firm, being aware that product Y would not be suitable given the client's financial situation, their investment objectives and their knowledge and experience, decides to influence him to buy product Y at his own initiative, for example by emphasising all possible advantages of such an investment. As a consequence, the client executes the transaction under the appropriateness test or execution only, without the protections afforded by the suitability assessment.

On the contrary, there might in practice also be situations (see, for example, Case 3 below) where the firm is confronted with clients who insist in taking a course of action that the firm has assessed as being unsuitable for him/her, therefore acting against the firm's advice (so called 'insistent clients').

CASE 3: Client C has an ongoing relationship with Firm W for the provision of investment services, including investment advice.

In the context of this relationship, client C contacts the firm at its own initiative, asking its advice about what investment he should choose between product A and product B. The firm, that does not have any specific interest in selling either of the mentioned products, undertakes a suitability test and assesses that only the investment in product B is suitable for client C, but despite the firm's recommendation, the client insists in buying product A. Client C will therefore execute the transaction under the appropriateness test (if the product is complex) or at his own risk, in execution-only (if the product is not complex and the transaction is regarded as being at the client's initiative), despite the firm's advice not to buy product A.

In situations where the client insists in proceeding with the transaction at his/her own initiative, against the firm's advice, that client should be clearly informed of the fact that the course of action that he/she wishes to undertake is not suitable for him/her, including a clear explanation of the potential risks he would incur into by doing so.

In order to ensure compliance with MiFID II framework, firms should in any case put in place arrangements enabling them to retrace and keep records of the steps of their interaction with clients, so as to be able to demonstrate whether the transaction executed was indeed originated by the client's initiative[8] or by the firm's initiative. Firms should periodically review these records to monitor that the interaction with their clients was correctly conducted and to identify potential practices and behaviours non-compliant with MiFID II rules. For example, recurring switches from investment advice to execution services at the client's initiative, or changes of client's profiles near the closing date of any transaction, not supported by a real modification of the client's situation that would justify such a change.

There are particular instances, such as firms selling their own financial instruments (or selling financial instruments issued by entities of the same group) or actively marketing products from within the firm's range, where there is a heightened risk that a firm might indeed act in accordance with its own interests, rather than in the best interests of its clients. In such circumstances, where there is a heightened risk of non-compliance with MiFID II rules due to the existence of significant conflicts of interests, firms may also decide, of their own accord and where compatible with national laws, to put in place processes and procedures that do not allow the client to proceed with a transaction under execution services in relation to a specific financial instrument if that instrument is unsuitable for him. Similar arrangements could also be adopted in relation to insistent clients.

Firms remain subject to all relevant MIFID II requirements and, in particular, to the overarching obligation of acting in accordance with the best interests of their clients.

Question 7 [Last update: 10 October 2016]

When a firm provides the investment service of advice or portfolio management to a client who is unwilling to fully disclose information on his/her financial situation, can the firm assess the suitability of the envisaged transaction? If yes, under which conditions?

Answer 7

When providing investment advice or portfolio management services, the firm must collect from the client all 'necessary information' required by Article 25(2) of MiFID II and Article 54(2) of the MiFID II Delegated Regulation. Moreover, paragraph 8 of the aforementioned Article 54 clarifies that in cases where the investment firm does not obtain such information, it shall not recommend investment services or financial instruments to that client or potential client.

The required information has to be considered in light of all the features of the investment advice or portfolio management services. In any case, the firm has to be able to assess the client's ability to understand and financially bear the relevant risks associated with the

[8] Recital 85 of MiFID II states that "*a service should be considered to be provided at the initiative of a client unless the client demands it in response to a personalised communication from or on behalf of the firm to that particular client, which contains an invitation or is intended to influence the client in respect of a specific financial instrument or specific transaction. A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients.*"

investment. Nevertheless, the depth and detail of the required information are subject to the proportionality principle, for example they can vary depending on the complexity, risks and structure of the financial instrument and on the nature and extent of the service provided. In particular, it should be reminded that for more complex and risky products, as well as for the illiquid ones, the firm should consider whether more in-depth information may need to be collected, so as to be able to carry out the aforementioned assessment[9].

Accordingly, it is the responsibility of the firm to decide whether, in limited situations, the suitability of certain products could be assessed without getting full disclosure about a client's financial situation. That may be the case, for example, where a client discloses only a part of his/her assets but also provides adequate information to evidence all his/her existing liabilities (such as bank loans, outstanding debts, etc.), and that no further liabilities exist. In these situations, the information provided by the client about his/her liabilities needs to be comprehensive. The firm must be capable, on the basis of the information disclosed by the client, to assess whether the client's assets are sufficient for him/her to bear any related investment risks, including the possible losses that can occur when investing in the respective instrument.

In accordance with Article 54(7) of the MiFID II Delegated Regulation, firms are responsible for ensuring that the information collected from clients is reliable and need to take reasonable steps to this effect. They could, for example, check such information against other relevant sources that may be available to the firm itself[10].This could be the case, for example, for a bank providing not only investment services, but also traditional banking services, that may have knowledge of an existing bank loan or other outstanding debts and liabilities. In any case, if the firm becomes aware that the information provided by the client about his/her existing liabilities is not accurate, it should refrain from giving investment advice or offering portfolio management services.

The fact that the suitability of the product/service was assessed without getting full disclosure about the client's financial situation should also be set out clearly in the suitability report provided to the client.

[9] This is in line with ESMA's 'Guidelines on certain aspects of MiFID suitability requirements' published in 2012 [Ref: ESMA/2012/387].
[10] This is in line with ESMA's 'Guidelines on certain aspects of MiFID suitability requirements' published in 2012 [Ref: ESMA/2012/387].

3 Recording of telephone conversations and electronic communications’ [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Which internal telephone conversations or electronic communications regarding the handling of orders and transactions need to be recorded?

Answer 1

Internal telephone conversations and electronic communications that *“are intended to result in transactions”* or “*relate to”* the reception and transmission of orders, execution of orders on behalf of clients and dealing on own account are subject to the MiFID II Article 16(7) recording requirement.

Recital 57 of MiFID II sets out that: *“such records should ensure that there is evidence to prove the terms of any orders given by clients and its correspondence with transactions executed by the investment firms, as well as to detect any behaviour that may have relevance in terms of market abuse, including when firms deal on own account”*.

As an example, such records should include conversations or communications by which the sales desk will request a quote from the trading desk on a financial instrument before concluding a transaction with a client. It may also include conversations or communications that are within scope and made to or from the sales and research desks.

Therefore, ESMA expects firms to record all internal telephone calls or electronic communications regarding the handling of orders and transactions. However, ESMA would not ordinarily expect persons carrying on back-office functions to be captured by the requirements.

To clarify, the records of any internal face-to-face conversations that relate to the reception and transmission of orders, execution of orders on behalf of clients and dealing on own account will be caught by the general record-keeping requirements under Article 16(6) of MiFID II.

Question 2 [Last update: 10 October 2016]

Can firms charge their clients to access recordings?

Answer 2

MiFID II enables clients to request access to records of telephone conversations and electronic communications kept in accordance with Article 16(7) of MiFID II. ESMA considers that a decision on whether to charge a client for access to such records is within the discretion of the firm. There is no prohibition in MiFID II on this point. However, firms are expected to pay due regard to the national laws in their respective jurisdiction on whether it is permissible to charge clients to access recordings[11].

ESMA therefore expects that, if a firm decides to charge its client, any charge must be reasonable in order not to deter clients from making such requests.

Question 3 [Last update: 10 October 2016]

The MiFID II Delegated Regulation requires firms to periodically monitor the records of transactions and orders subject to these requirements including relevant conversations and that the monitoring shall be risk based and proportionate. How should these requirements be applied?

Answer 3

The monitoring of records of relevant telephone conversations and electronic communications is necessary to assist the firm in ensuring that it is meeting the recording requirements and also adhering to its wider regulatory obligations under MiFID II. For example, it will assist the firm in meeting its wider regulatory obligations which include but are not limited to having policies and procedures in place in respect of its client order handling, best execution, own account dealing obligations and the deterrence and detection of market abuse.

In determining the firm's approach to monitoring the recording requirements, which includes the frequency and scope of such monitoring, ESMA expects firms to put in place arrangements which are appropriate to the nature, size and complexity of its business.

The approach should consider the likelihood of misconduct in relation to market manipulation or non-compliance with the obligation to act in the best interest of clients in connection with the reception, transmission and execution of client orders and when dealing on own account. In any case, the following criteria should be taken into account when determining the appropriate frequency and scope of monitoring the records: (i) volume and frequency of dealing on own account, (ii) volume, frequency and characteristics of client orders, (iii) characteristics of clients, (iv) financial instruments and services offered and (v) current market conditions with regard to specific securities. This list is non-exhaustive.

Furthermore, the results of any monitoring activities (including the risk assessment carried out by the compliance function) and of any relevant internal or external audit findings on the recording of conversations and electronic communications should be taken into account to determine the frequency and scope of the monitoring.

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[11] Firms should bear in mind that the Article 12 of the Data Protection Directive 95/46/EC states that every data subject should be guaranteed a right of access "*without excessive delays or expense*".

The monitoring should be conducted regularly and when necessary on an ad-hoc basis. Due regard should also be given to any emerging risks.

The monitoring should at least aim at:

- assessing compliance with recording procedures in place,
- assessing the adequacy of such procedures,
- ensuring that the records are readily accessible; and
- ensuring that the records accurately reconstruct the audit trail of a transaction.

Question 4 [Last update: 10 October 2016]

Under Article 16(7) of MiFID II, competent authorities may request that a firm keeps the records for up to a period of seven years, rather than five years. In such cases, what are the expectations by competent authorities on the retention of records?

Answer 4

Firms are required to keep records produced under Article 16(7) of MiFID II for five years, with the extension to seven years, if requested by the competent authority. For example, extensions may occur when a competent authority undertakes complicated regulatory investigations in the course of exercising its supervisory powers. This can also occur, for instance, when the competent authority is conducting an investigation on an issue dating several years prior to the start of the inquiry. If a competent authority has not made a request to a firm to put aside recordings within five years from the beginning of the retention period, the firm does not have to keep those recordings for longer than five years from when the record was created. However, if within five years from when the record was created, a competent authority asks firms to retain the recordings, recordings should stop being deleted and should be retained until the competent authority needs them or the competent authority indicates that the recordings are no longer of interest.

Where a firm has been asked to preserve information which may be of interest and the competent authority subsequently concludes that they have no further interest in that information, the competent authority should inform the firms as quickly as possible. If a firm is unclear on whether it should continue to retain material, it should contact the competent authority for confirmation of the position. Nevertheless, no request from the competent authority can extend the retention period for firms beyond seven years.

Question 5 [Last update: 10 October 2016]

What types of electronic communications are within the scope of the new requirements?

Answer 5

Article 16(7) of MiFID II requires the recording of telephone conversations or electronic communications. Any electronic communications involving transactions when dealing on own account or in the provision of client order services that relate to the reception, transmission and execution of client orders will fall within the rules. The term "electronic communication" covers many categories of communications and includes amongst others video conferencing, fax, email, Bloomberg mail, SMS, business to business devices, chat, instant messaging and mobile device applications.

ESMA will not produce an exhaustive list of electronic communications because of the continuing innovation and advancement in technology which would mean the list frequently becomes out of date.

Question 6 **[Last update: 10 October 2016]**

Is the compliance function sufficient to fulfil the requirement to periodically monitor the records of transactions and orders? Or should it be a separate, specifically organised function?

Answer 6

MIFID II, and its implementing measures, do not require the establishment of another control function on top of those already provided for by MIFID I: compliance function, risk management function and, where appropriate, internal audit function. Firms are reminded of their requirements under Article 9(3) of MiFID II and Article 76(2) of the MiFID II Delegated Regulation.

Therefore, while not being necessarily another specific control function, the periodic monitoring of the records of relevant telephone conversations and electronic communications is an essential piece of the overall compliance and monitoring system a firm has to implement through governance arrangements.

Question 7 **[Last update: 10 October 2016]**

Is the recording of telephone conversations and electronic communications a critical or important operational function for the purposes of the outsourcing rules?

Answer 7

Firms may use third-party recording services to meet the new requirement to record telephone conversations and electronic communication. However, ESMA considers that, for the purposes of the outsourcing rules, taping will be considered a critical or important operational function.

Question 8 [Last update: 10 October 2016]

Do relevant telephone conversations and electronic communications need to be recorded by the firm from start to end?

Answer 8

In ESMA's view, the scope of the requirements require firms to record the entirety of telephone conversations and electronic communications. This is because it is impossible to appreciate upfront whether the conversation will lead to the conclusion of a transaction.

Therefore, ESMA expects firms to record all relevant telephone conversations or electronic communications from start to end.

Question 9 [Last update: 10 October 2016]

MiFID II enables clients to request access to records of their telephone conversations and electronic communications with the firm. Does this right also cover internal communications within the firm?

Answer 9

MiFID II states that records kept in accordance with Article 16(7) of MiFID II shall be provided to the client involved upon request. This extends to internal conversations and communications between employees and contractors of the firm which relate to the provision of the client's order.

Question 10 [Last update: 10 October 2016]

Are employees or contractors permitted to use mobile devices to enable them to undertake activities relating to transactions concluded when dealing on own account and the provision of client order services?

Answer 10

Firms may permit relevant persons to use mobile devices to undertake activities relating to transactions concluded when dealing on own account and the provision of client order services. This includes devices owned by the firm which are expressly authorised for use and devices which are personally owned and used to make relevant conversations. Whatever the circumstance, a firm shall take all reasonable steps to prevent a relevant person from making, sending or receiving relevant telephone conversations and electronic communications on devices which the firm is unable to record or copy.

Firms are required to establish, implement and maintain an effective recording of telephone conversations and electronic communications policy. This policy should therefore cover the requirements relating to mobile devices.

For example, the policy should cover, amongst other factors, the fact that data must be retained for a period of at least 5 years, relevant persons should be prevented from being able to delete records. It should cover what happens to the data/device if a relevant person leaves a firm and what happens in the event that the device is lost or stolen. Additionally, it should also stipulate the frequency of transferring data from the mobile device (whether privately owned or expressly authorised for use by the firm) to the firm's own data retention database.

Question 11 [Last update: 10 October 2016]

What telephone conversations and electronic communications should be recorded in accordance with Article 16(7) MIFID II?

Answer 11

In ESMA's view, the following stages of conversations and electronic communications[12] that relate to the provision of client order services or dealing on own account will be caught by the rules:

- Conversations or communications with a client, or a person acting on behalf of such a client, which relate to an agreement by the firm to carry out one of the covered activities, whether as principal or agent.

- Conversations or communications with any other person, which relate to transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. This should include telephone conversations or electronic communications such as: transmitting an order to a broker or placing an order with an entity for execution, conversations or communications relating to the handling of an order (including solicitations and acceptance of transactions).

Also included, are any other conversations or communications which are carried out by the firm with a view to reach an agreement to carry out one of the covered activities, whether as principal or agent, even if those conversations or communications do not lead to the conclusion of such an agreement[13]. This should include conversations and communications regarding prices, solicitations, bids, offers, indications of interest and requests for quotes.

[12] For example, transactions concluded through online websites, online platforms and smart phone applications.
[13] Second sub-paragraph of Article 16(7) MiFID II.

Firms should have in place policies and procedures to ensure that no relevant telephone conversations or electronic communications are done through communication systems which are not recorded.

Firms will have to decide which devices these relevant conversations or communications will take place on and ensure the effectiveness of their arrangements. Firms will have to ensure that relevant persons are trained on the procedures governing the requirements in Article 16(7) MiFID II[14].

[14] Article 76(5) of MiFID II Delegated Regulation.

4 Record keeping [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

How should firms prepare copies of records that have been encrypted and which have been requested by clients, competent authorities or other competent third parties?

Answer 1

For records that are captured by the requirements under Article 16(6) and 16(7) of MiFID II, ESMA expects firms to have the organisational and administrative capabilities to convert any encrypted data into an unencrypted format.

ESMA expects firms to deliver or make available copies of these records in an unencrypted and easily analysable format, or provide the means that such data can be unencrypted when requested by the client, competent authority or other competent third party.

5 Investment advice on an independent basis [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Could a firm still hold itself out as being independent where it assesses and compares a sufficient range of financial instruments available (which are not limited to financial instruments issued or provided by the firm itself or by entities having close links) but that the outcome of such an assessment in a considerable number of cases is that the firm recommends financial instruments to its clients which are issued or provided by the firm itself or by entities having close links?

Answer 1

When a firm holding itself out as being independent frequently assesses financial instruments which are issued or provided by the firm itself or by entities having close links as best suited for its clients, ESMA considers this could potentially conflict its status as 'independent'.

Independent advisers are reminded of their obligations stemming from MiFID II (and in particular Article 24(4) and 24(7)) and implementing measures (in particular Articles 52 and 53 of the MiFID II Delegated Regulation). A firm is also expected to manage conflicts of interest at all times. In doing so, the firm should establish, implement, maintain and update regularly adequate internal systems and controls in order to ensure that it is not bound by any form of agreement with a product provider that may limit the firm's ability to provide a personal recommendation which is unbiased and based on an assessment of a sufficient range of financial instruments available on the market. Also a regular review of the service and financial instruments it offers should be performed by the firm. Consequently, ESMA expects that these internal controls and systems should provide for a permanent internal awareness of its independency status.

In practice this means that the outcome of the unbiased and unrestricted analysis of the financial instruments available on the market could occasionally result in the firm recommending its own products. However, if the outcome is that the firm routinely recommends its own products or if there appears to be a systematic bias to advise clients to invest in its own products, the firm would most likely have problems in demonstrating the provision of advice on an independent basis. In such a case ESMA expects the firm to do thorough internal assessments determining if and to what extent clients' interests are or could be affected. Such an internal assessment should at least consider information on how the firm assessed and compared financial instruments which are issued or provided by the firm itself or by entities having close links versus a sufficient range of financial instruments available on the market. Also it should make clear the factors the assessment has been based upon and which factors determined the outcome. The firm should be able to provide this analysis to its clients and on request to the supervisory authority.

6 Underwriting and placing [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

Article 38(1)(a) of the MiFID II Delegated Regulation states that "investment firms which provide advice on corporate finance strategy, as set out in Section B (3) of Annex I, and provide the service of underwriting or placing of financial instruments, shall, before accepting a mandate to manage the offering, have arrangements in place to inform the issuer client of the various financing alternatives available with the firm". What are "the various financing alternatives" to be considered?

Answer 1

The various financing alternatives may be limited to those appropriate to the issuer client's needs. However, they should not be limited to financing alternatives that constitute investment services; for example, loans or extension of credit facilities shall be included if appropriate and offered by the firm. The firm should inform the issuer client which financing alternatives have not been considered, including financing alternatives not offered by the firm, with a short explanation of why they were discounted.

7 Inducements (research) [Last update: 10 October 2016]

Question 1 [Last update: 10 October 2016]

When a firm is using a research payment account under Article 13 of the MiFID II Delegate Directive, can the research budget required under Article 13(1)(b)(ii) and 13(2)(a) be set for more than one client's portfolio when determining the specific research charge to a client and establishing the need for third party research?

Answer 1

While a research payment account (RPA) can only be funded by a specific research charge to the client, which must be based on a research budget set by the firm, ESMA considers that a budget can be set for a group of client portfolios or accounts where the firm has established a similar need for third party research in respect of the investment services rendered to its clients.

This would allow a firm providing investment services to set a research budget at a desk or investment strategy level, for example, if client portfolios have sufficiently similar mandates and investment objectives such that investment decisions relating to those portfolios are informed by the same research inputs. A firm should be able to clearly evidence and demonstrate its approach to setting and managing a budget for a given group of client accounts and that it is consistent with using the budget in the best interests of its clients, as required by Article 13(6) of the MiFID II Delegated Directive. A firm should also describe its approach in a written research policy provided to its clients under Article 13(8) of the MiFID II Delegated Directive.

A firm is still required to identify a specific research charge for individual clients to fund the RPA, even where a budget is set for several portfolios. A firm will therefore need to have a transparent method for making a fair allocation of costs in such cases. This may involve the firm pro-rating the cost of the research budget across all client accounts benefitting from it based, for example, on the value of each client's portfolio, to establish a specific charge for individual clients.

Firms should not set a budget for a group of client portfolios or accounts that do not share sufficiently similar investment objectives and research needs. For example, if portfolios have material differences in the types of financial instruments and / or geographic regions or market sectors they can invest or are invested in, such that their research needs and the potential costs of acquiring those inputs are different, they should not be subject to the same research budget. This would not allow the firm to ensure a budget is used in the best interests of clients and may result in an unfair allocation of the costs, or benefits derived from research purchased, between different sets of clients. A firm may also choose to set a firm-level research budget to help it control overall costs, but this does not replace the need to set budgets for discrete groups of client portfolios and accounts as described above.