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## AVOCATS



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## The Right Product for the Investor

Me Christophe Wilhelm attended in Brussels on November 17, 2015 the MiFID II workshop organized by Markus Ferber of the ECON Committee of the European Parliament. This workshop is intended to give an in-depth insight into the regulatory goals of MiFID II and the implementation of those goals into practice.

On November 17, 2015, the Workshop was organized to address the issues of The Right Product for the Investor.

This issue is one of the most crucial one for the implementation of MiFID II regulations. It is an easy issue to understand but very complex to implement from the regulator perspective.

Of course, according to Mr. Ferber, the client cannot be fully relieved from any risk. On the other hand, the regulator has to take into account the asymmetry of the relationship between the bank or the investment firm, on one hand, and the client, on the other hand. This dilemma is solved when the client is thinking in terms of what is the best interest of the client.

This paper will address the following issues linked to this theme:

### 1. Suitability Test:

This issue is addressed by the Article 25 of the EU Treaty. When providing an investment advice the bank should be able to evidence the rationale behind the advice given to the client. This should be provided in a “durable” medium (10 years at least) and electronically. The suitability report is within the responsibility of the investment firm. The recommendations to the client should be phrased in a way allowing the client to make the most appropriate choice based on his personal situation.

Information about the client needs to be collected by the investment firm before providing advice to the client and before proposing to the client a specific financial product. For instance, the firm should have knowledge about the capacity of the client to bear losses or what is his risk tolerance. The firm should also get information about the level of understanding of the client to the complexity of the proposed financial product. Investment objectives of the client should also be requested and investigated on a case-by-case basis.

Should these elements not be gathered by the investment firm, the firm should clearly state to the client that it is not able to propose him a solution to his needs of investment. This warning should also be duly documented and provided in a standardized format.

Suitability also requires from the investment firm to communicate in a comprehensive and clear way. It should be easy to be understood by the client. Providing and interacting with the client in digital and automated way is not sufficient to meet the suitability test.

The information provided should also be reliable. This means that the information provided by the firm is up-to-date and accurate.

The tools used by the investment firm should also be maintained and fit for purpose. For example, if a mere student is asking for financial investment advices, the system put in place by the firm should be able to detect that this student is not supposed to have - prima facie - the capacity to meet the suitability test in case of purchase of complex financial products.

If the client is a legal person or the client is more than one person, the investment firm should investigate on who – i.e. among the circle of the natural persons entitled to represent it – should be subject to the suitability assessment.

In case of professional client, the firm is allowed to assume that this kind of client has the necessary knowledge to understand properly the risk of the financial product at stake. This has also to be documented.

Of course, the best way to perform a suitability test is a face-to-face meeting. However, this is not always possible. Different alternatives have to be made possible by the investment firm to validate the test whenever possible.

## **2. Appropriateness Test:**

This is the general information to be collected by the investment firm. This is basically the same test as the suitability one, but linked to the timing of the investment. Records of the appropriateness assessment have to be kept.

## **3. Knowledge and Experience:**

It requires the investment firm to at least collect the following information:

- To what kind of product is the client used to;
  - The frequency and the volume of investment the client is used to;
  - The capacity of the client to understand the complexity of the proposed product.
- This, of course, has also to be formally documented.

## **4. Complex and Non-Complex Products:**

If the services are provided on an execution only basis, investment firms have not to comply with the appropriateness test. If a financial instrument is deemed to be “non-complex”, the level of the appropriateness and of the suitability tests is also supposed to be reduced.

The draft of the level II of the MiFID regulations set forth as a basis that all financial products are complex.

However, a financial products may be deemed non-complex if (non-exhaustive list):

- There is no risk of total loss,
- The product is proposed very frequently to the considered type of investor;
- The complexity of the product is supposed to be readily understood by an average-based retail client;
- Structured products are supposed to be complex;
- Shares embedded in a derivative is also supposed to be complex;

## **5. Enabling Decision Making (Displaying Risk):**

Risk is an issue on macro level (see the “too big to fail” issue). On a financial perspective level, risk is correlated to volatility: “how much am I going to lose and how likely this is to happen?”

What has been exposed above is of course valid to measure the risk. However, investment firms are advised to put in place a risk indicator.

How is a risk indicator supposed to look like? According to Mr Ferber, such risk indicator should bear the following features:

- Such tool should be comprehensible to laymen;

- It should be very easy to be understood;
- It should be produced and updated by an independent party;
- It should be easy to obtain to update;
- It should focus on loss potential.

According to Mr Ferber, the risk indicators in PRIIPS (Package Retail and Insurance-based Investment Products - see Regulation No 1286/2014 of the EU Parliament on key information for PRIIPS) are not meeting these requirements and might be seen as misleading.

## **6. Treatment of Research:**

In the actual draft of the delegated Act of MiFID II there is no distinction on the different kinds of research. The regular regime shall therefore apply no matter if the client is making his choice based on his own research or based on a research based on his investment firm.

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