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SUMMARY OF SPOT INSPECTIONS ON COMPLIANCE WITH THE NEW MiFID 2 PROVISIONS ON PORTFOLIO MANAGEMENT FOR THIRD PARTIES

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INTRODUCTION

As announced in the AMF's supervision priorities for 2019, a series of short thematic "SPOT"[1] inspections relating to portfolio management for third parties ("portfolio management") was carried out in 2019. These inspections were conducted as part of the new provisions introduced by Directive[2] 2014/65/EU of 15 May 2014 on markets in financial instruments ("MiFID 2"), supplemented by Commission Delegated Regulation (EU) 2017/565 of 25 April 2016. The SPOT inspections involved a sample of five investment services providers ("ISPs") targeting exclusively credit institutions authorised to provide portfolio management services on behalf of third parties. The inspections carried out covered the period 2018-2019.

The main objective of this series of SPOT inspections was to ensure the quality of information provided to clients receiving portfolio management services. Therefore, particular attention was paid to: *(i) the compliance of client questionnaires; (ii) the periodicity and the content of periodic management statements; (iii) disclosures relating to charges on an ex-ante and ex-post basis; (iv) the early warning system used when the value of the portfolio falls by more than 10%; and (v) information relating to the rules when receiving any commission rebates.*

The purpose of this review is to provide an insight into the practices of ISPs providing portfolio management services in terms of the systems implemented to provide their clients with comprehensive, high-quality information as required by the regulations.

This document is neither a position nor a recommendation. The practices identified as either "good" or "poor" highlight approaches identified during the inspections that may facilitate, or complicate, compliance with regulations governing portfolio management.

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1 *Supervision des Pratiques Opérationnelle et Thématique* – operational and thematic supervision of practices.

2 Directive 2014/65/EU of 15 May 2014 on markets in financial instruments, transposed by Executive Order no. 2017-1107 of 22 June 2017 and effective as of 3 January 2018.

1. SUMMARY OF THE MAIN FINDINGS OF THE INSPECTIONS

Generally speaking, the inspection task force noted a significant effort by the ISPs inspected in connection with the new MiFID 2 provisions that apply to portfolio management services for third parties. However, very few practices that could be considered good practice were found. The inspections also revealed that, from an organisational perspective, the resources implemented by the five ISPs were not always sufficient to enable the new MiFID 2 regulatory requirements to be fully and effectively implemented.

Firstly, the inspection task force conducted a detailed analysis of the client questionnaires used to collect information that enables the ISP to assess the suitability and appropriateness of the investment service or financial instrument being offered. In particular, the task force identified varying degrees of responsiveness in rolling out the new questionnaires to clients who took out a contract before the new MiFID 2 provisions came into force (i.e. 3 January 2018). Furthermore, four institutions introduced questionnaires that did not include questions enabling the ISPs to assess the client’s risk tolerance and ability to bear losses. Neither of these practices comply with the regulations.

Secondly, the task force found that the rules on the frequency of providing periodic management statements were correctly implemented for all the institutions inspected. In terms of content, enhancing the content of the statements by including comments aimed at justifying the individual (buy, sell and arbitrage transactions) or collective (through UCITS and AIFs) management activities was noted as a good practice. However, the inclusion of general comments without any specific statements of the client’s management profile, which is a poor practice, was also noted at three institutions.

Thirdly, the task force analysed the content of the ex-ante and ex-post information on costs and charges borne by the client. No good practices were observed in this area, and there is still room for improvement at all the institutions inspected in terms of reporting portfolio management costs and charges to the client. In this regard, shortcomings were observed relating to *(i) the presentation format, which did not show costs on an aggregated basis, (ii) the exhaustiveness of the fees charged, not all of which were provided, and (iii) the impact of the charges on the performance of the portfolio, which was not consistently presented.* These shortcomings represent a failure to comply with the regulations.

Fourthly, the task force analysed the system for informing clients of falls of 10% in the value of their portfolio (and thereafter at multiples of 10%). Several good practices were identified, in particular relating to the implementation of an ex-ante control system, through analysis by the middle office prior to sending alerts, and the implementation of an ex-post control system designed to verify the successful receipt of the alert message. In addition, one institution includes the actual rate of decline in the portfolio value at closing in its alert message. However, the task force also identified cases of alerts arriving too late (after D+1), which is in breach of the regulations, and cases of “false alarms”, which may have been generated as a result of management activities (e.g. a client’s withdrawal of securities or cash) that had not been reprocessed, thus artificially and erroneously influencing the portfolio’s performance. This is considered a poor practice.

Lastly, the inspection task force analysed the implementation of the provisions prohibiting ISPs from retaining commission rebates that they may have received. For all of the institutions inspected, the task force identified shortcomings:

- ✓ either because of the existence of contractual documents referring to rebates received, even though the institution had stopped receiving them;
- ✓ or because of inconsistencies between various documents within the same institution (due to versioning problems).

2. CONTEXT AND SCOPE

2.1. PRESENTATION OF THE SAMPLE OF ISPs INSPECTED

These SPOT inspections were carried out simultaneously in five credit institutions authorised to carry out portfolio management services for third parties as referred to in Article L. 321-1 4 of the Monetary and Financial Code. Of these institutions, two are subsidiaries of French banking groups, two are independent French institutions and one is established in France as a branch of a banking institution with its headquarters outside the EU. The criteria used to select the five institutions chosen by the task force were as follows:

- Portfolio management services provided directly to third parties (without delegating management activities).
- A significant amount of assets under management (>€150m).
- A large proportion of retail clients.

2.2. TOPICS ADDRESSED AND METHODOLOGY USED

The following topics were addressed during these inspections:

- The inclusion of questions in new Know Your Client questionnaires enabling the ISP to collect information from the client that it can use to assess the client's risk tolerance and ability to bear losses;
- Compliance with the quarterly frequency of periodic management statements, except in exceptional cases,[3] and the fair and balanced nature of the information contained in these reports;[4]
- Information provided to clients on costs and related charges on an ex-ante and ex-post basis;
- The system put in place by the institution in the event of a fall of 10% in the value of a managed portfolio (and thereafter at multiples of 10%) in order to comply with the requirement to provide information to the client;
- The prohibition on the retention by the institution of commission rebates received in connection with portfolio management.

For each of the five institutions inspected, the inspection task force analysed the procedures currently in place, the new MiFID 2 templates for discretionary mandates and the new MiFID 2 templates for Know Your Client questionnaires. To assess the operational implementation of the aforementioned requirements and systems, the inspection task force carried out a more detailed examination by taking two samples from each of the institutions inspected:

- The first sample consisted of 10 client files containing all the management profiles offered by the institution (five mandates signed before 3 January 2018[5] and five mandates signed after 3 January 2018). This sample was used to verify the information provided in the discretionary mandates, the frequency and content of the periodic management statements and the ex-ante and ex-post information on charges provided to clients;
- The second sample consisted of 10 alerts sent following a fall in the value of a client's portfolio of 10% or more or of a multiple of 10%.[6] This sample was used to verify the system put in place by the institution and the information sent to clients (content, medium and time frame) after an alert concerning a fall in the value of their portfolio had been triggered.

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3 As referred to in Article 60(3) of Delegated Regulation (EU) 2017/565.
4 As referred to in Article 60(2) of Delegated Regulation (EU) 2017/565.
5 Date the new MiFID 2 regulations entered into force.
6 Compared with its value "at the beginning of each reporting period" in accordance with Article 62(1) of Delegated Regulation (EU) 2017/565, which in practice means compared with its value at the end of the previous quarter where the periodic management statement is sent quarterly.

2.3. APPLICABLE REGULATIONS

The work of the inspection task force was based in particular on:

- The Monetary and Financial Code, in particular the articles resulting from the transposition of MiFID 2;[7]
- Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing MiFID 2;
- The ESMA Q&A document ESMA 35-43-349 (latest update of 18 February 2020).

Main legal sources

<u>Assessment by the ISP of the client's ability to bear losses and their risk tolerance</u>

- ✓ Article L. 533-13 of the Monetary and Financial Code concerning the obligation of ISPs to obtain the information they need from clients or potential clients to be able to recommend investment services and financial instruments that are suitable and appropriate to the client's risk tolerance and ability to bear losses;

- ✓ Article 54 of Delegated Regulation (EU) 2017/565 specifying the content of the information to be collected and the arrangements to be put in place so that ISPs can assess the suitability of the service offered.

<u>Periodic management statement</u>

- ✓ Article 60 of Delegated Regulation (EU) 2017/565 on reporting obligations for ISPs in respect of portfolio management services.

<u>Information provided to clients on costs and charges</u>

- ✓ Article L. 533-12 of the Monetary and Financial Code concerning the obligations of ISPs to inform their clients and potential clients in a timely manner of all management costs and associated charges;
- ✓ Article 50 of Delegated Regulation (EU) 2017/565 specifying the requirements and calculation methods that apply to the ex-ante and ex-post disclosure of information on costs and associated charges;
- ✓ Annex II of Delegated Regulation (EU) 2017/565, which lists and illustrates the nature of the costs and associated charges to be disclosed to clients.

<u>System used to alert clients in the event of a 10% fall in portfolio value (and thereafter at multiples of 10%)</u>

- ✓ Article 62 of Delegated Regulation (EU) 2017/565 on the obligation of ISPs to inform their clients of any fall of 10% in value and thereafter at multiples of 10%;
- ✓ Chapter 8. "Post-sale reporting" – Questions/Answers 1 and 7 of the ESMA Q&A 35-43-349 on the obligation of ISPs to inform their clients of any fall of 10% in value and thereafter at multiples of 10%.

<u>Application of restrictions on commission rebates</u>

- ✓ Article L. 533-12-3 of the Monetary and Financial Code prohibiting ISPs from retaining any commission rebates that they may have received.

[7] Executive Order no. 2017-1107 of 22 June 2017 and effective as of 3 January 2018.

3. OBSERVATIONS AND ANALYSES

As a general remark, with regard to the new MiFID 2 provisions on portfolio management, the five institutions inspected have reached varying degrees of compliance.

Improvements and further developments are therefore still needed in all topics addressed by this inspection assignment:

- Enhancing and revising the Know Your Client questionnaires, and more generally all contractual documentation provided to the client (discretionary mandate, general and specific conditions, annexes, etc.);
- Improving the content and reliability of the periodic management statements, particularly with regard to the management activities actually carried out on the client's account;
- Improving the content and accuracy of the ex-ante and ex-post information statements on management costs and associated charges;
- Improving the timeliness, content and accuracy of the information provided to clients in the event of a fall in the value of their portfolio;
- Improving information provided to the client, particularly in contractual documents, on whether commission rebates are received and, if they are, whether they are refunded to the client.

Lastly, it should be noted that some of the findings of the inspection task force have already been incorporated, by the institutions concerned, into the new templates for discretionary mandates and MiFID 2 client questionnaires. Other findings are subject to changes that were still in progress or forthcoming at the time this review was written. In particular, many were pending internal validation within the institution.

3.1. NEW "MiFID 2" CLIENT QUESTIONNAIRE TEMPLATES

The new MiFID 2 provisions have clarified and strengthened the obligations on ISPs with regard to collecting client information that enables them to better assess a client's suitability when proposing an investment service. Article L. 533-13 of the Monetary and Financial Code, which transposed MiFID 2 into French law, introduced new requirements in this area, particularly in the case of portfolio management services for third parties, where ISPs must obtain the information that they need about a client's financial situation and investment objectives to enable them to recommend *"investment services and financial instruments that are suitable and appropriate to the client's risk tolerance and ability to bear losses"*. The actual implementation of these provisions has been clarified by Article 54 of Delegated Regulation (EU) 2017/565, which details the content and arrangements to be put in place to enable ISPs to assess the suitability of the proposed service.

Generally speaking, all the institutions inspected have developed a new template for a Know Your Client questionnaire that takes account of the new MiFID 2 provisions. The analysis of these new templates revealed that the information collected for assessing a client's risk tolerance and ability to bear losses is often insufficient because it is incomplete. Furthermore, the rate at which the new Know Your Client questionnaires were being deployed[8] was either not assessed by the institutions or was insufficient considering the date on which the new MiFID 2 provisions came into force (3 January 2018).

In greater detail, the inspection task force found that:

- Only one institution had implemented a client questionnaire that effectively assessed a client's risk tolerance and ability to bear losses by asking multiple questions. This ability was calculated based on the client's financial capacity and taking account of criteria such as their age, investment horizon and investment objectives.

[8] This deployment rate is the number of new MiFID 2 questionnaires submitted by clients compared with the total number of MiFID 1 and MiFID 2 Know Your Client questionnaires for a given institution.

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This institution's Know Your Client questionnaires were updated with the new MiFID 2 provisions in advance of the new provisions coming into force on 3 January 2018.

- By contrast, the other four institutions used a Know Your Client questionnaire template that did not enable the institutions themselves to assess a client's risk tolerance and ability to bear losses (as opposed to self-assessment by the client) because the questionnaires collected insufficient information. Furthermore, updates to the questionnaires for clients who had registered prior to 3 January 2018 (the date of entry into force of MiFID 2) had still not been completed at the end of 2019. These practices do not comply with the regulations.

  - ✓ Two of these four institutions had no plan to update the old questionnaires (i.e. updating a new MiFID 2 questionnaire for clients with a discretionary mandate before 3 January 2018 insofar as their accounts are still managed under mandate). These two institutions were not therefore in a position to communicate a deployment rate for the new questionnaires. Furthermore, for one of these two institutions, the concepts of "risk tolerance" and "ability to bear losses" were not clearly defined in the questions asked to clients.

  - ✓ The other two institutions had developed a plan for updating their questionnaires, but their rate of progress was not sufficient for this to be completed by the time of the inspection (60% by the end of September 2019 with a target of 100% by the end of December 2019 for one institution) or was not sufficiently ambitious (100% by the end of 2021 for the other institution, which agreed to bring this deadline forward to the end of 2020 in its letter of comments).

3.2. FREQUENCY AND CONTENT OF PERIODIC MANAGEMENT STATEMENTS

Under the new MiFID 2 provisions, ISPs providing a portfolio management service must send a periodic management statement on a quarterly basis, except in the cases referred to in Article 60(3) of Delegated Regulation (EU) 2017/565.[9] The content of the statement must *"provide a fair and balanced review of the activities undertaken and of the performance of the portfolio during the reporting period […]"* as described in Article 60(2) of Delegated Regulation (EU) 2017/565.

In practice, all five institutions inspected send quarterly management statements to their clients with discretionary mandates, in accordance with the new frequency requirements.

- Two institutions had developed periodic management statements that met the requirements for "fair and balanced" reporting. In particular, they detailed the management activities carried out during the period (details of buy, sell and arbitrage transactions) and the performance of the portfolio managed. These statements were personalised to reflect the client's management profile and the movements and actual performance of the portfolio.

  One institution's periodic management statements included, for managed portfolios invested in collective investment products, comments on the main funds in which the portfolios were invested.

- For three institutions, the periodic management statements did not detail all the management activities (buy, sell and arbitrage transactions) carried out over the period in question.

  The performance of the managed portfolio was provided in the statements. However, the statements did not explain any differences between the performance of the managed portfolio and the performance of the benchmark index, particularly when the portfolio had underperformed in relation to the index.

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[9] Except where the ISP provides its clients with access to an online system with up-to-date evaluations of the client's portfolio, where the client has elected to receive information about executed transactions on a transaction-by-transaction basis, or where the client authorises a leveraged portfolio.

Lastly, instead of management comments, these statements contained comments of a general nature that were identical irrespective of both the management profile and the content of the client's portfolio.

For one of the three institutions in question, the following observations were made:

- ✓ The asset managers met regularly with their clients in order to review the management and performance of their clients' portfolios. However, this verbal practice is not sufficient to meet the new provisions that apply to periodic management statements.
- ✓ The same institution did not send a periodic management statement to clients if no management activities (buy, sell and arbitrage transactions) had taken place, for example after opening a managed account. However, not investing or not divesting constitutes a management decision, which warrants a periodic management statement being sent.
- ✓ Lastly, this institution's periodic statements included a disclaimer of responsibility for the accuracy and completeness of the information contained in the statements and/or for the suitability of the investment strategy chosen in relation to the client's profile. This is misleading for the client and does not therefore comply with the regulations.

Good practices:
- Commenting on and justifying the various management activities (buy, sell and arbitrage transactions) carried out on the client's portfolio (or the absence of transactions) for the quarter concerned, specifically for each management profile and for each managed portfolio.
- For a managed portfolio invested in a collective investment product, commenting on the management of the most representative UCITS and AIFs in the portfolio.

Poor practices:
- Stating the quarterly performance of the portfolio without qualifying it.
- Including management comments of a general nature without any specific statements of the client's management profile.

3.3. EX-ANTE AND EX-POST INFORMATION ON COSTS AND CHARGES BORNE BY THE CLIENT

With regard to ex-ante (in a timely manner before providing the portfolio management service) and ex-post (yearly) information provided to the client on management costs and associated charges, the inspection task force analysed the practices of the five institutions in relation to Articles L. 533-12 of the Monetary and Financial Code and Article 50 of Delegated Regulation (EU) 2017/565. Annex II of that Delegated Regulation lists and illustrates the nature of the costs and associated charges to be disclosed to clients.

The practices observed are quite diverse. The task force focused on verifying the accuracy and exhaustiveness of the format used to present the costs and charges disclosed to clients as well as its compliance with the regulations.

- Two institutions provide their clients with the information on management costs and associated charges required under the regulations:
  - on an ex-ante basis, using a simulation of costs and charges that was appended to the discretionary mandate;
  - on an ex-post basis, using ex-post information statements on costs and charges.

- However, the other three institutions did not provide full ex-ante and ex-post information on management costs and associated charges, which is not in compliance with the new MiFID 2 provisions.

  - ✓ For example, one institution provides the client neither with all the aggregated costs and charges associated with producing and managing the portfolio nor with a reasonable estimate of the expected costs and charges. Moreover, this institution provides a theoretical illustration of the costs and charges, as an example, but does not provide a simulation of the actual impact on the performance of the portfolio managed.

  - ✓ For a second institution, its discretionary mandate template and fee schedule do not comply with the new MiFID 2 provisions on ex-ante information on costs and charges. Moreover, the client is provided neither with all the aggregated costs and charges associated with producing and managing the portfolio nor with a reasonable estimate of the actual costs and charges expected. Lastly, the ex-post information statement does not mention either the charges related to financial instruments or the impact (as an amount and/or percentage) of ex-post costs and charges on the performance of the managed portfolio.

  - ✓ For a third institution, the costs and charges mentioned in the ex-post information statement are not exhaustive. Furthermore, it appears that six out of the ten ex-post statements audited contained incorrect charges.

3.4. CLIENT INFORMATION PROVIDED IN THE EVENT OF A 10% FALL IN THE VALUE OF THEIR MANAGED PORTFOLIO (AND THEREAFTER AT MULTIPLES OF 10%)

One of the new MiFID 2 provisions for portfolio management is that clients must be informed if the value of their portfolio falls by 10% (and thereafter at multiples of 10%). This new provision is governed by Article 62 of Delegated Regulation (EU) 2017/565, supplemented by the ESMA Q&A 35-43-349 (Chapter 8, "Post-sale reporting" – Questions/Answers 1 and 7). The supervision of the alert sending process could be adapted in case of exceptional circumstances, as a sanitary crisis.

The institutions inspected are at varying levels of compliance with this provision.

- One institution issues alerts for all managed portfolios in a timely manner.

- Two institutions issue alerts for all managed portfolios within the prescribed time frame but do not address either anomalies in the portfolio valuation calculation or the rejection of alerts when client contact information is missing or incorrect.

- One institution issues alerts for all managed portfolios, but these are sent outside the prescribed time frame (D+2, not within D+1), which does not comply with the regulations.

- One institution has been issuing alerts only since November 2018 and only for portfolios invested in live securities (and not for portfolios invested in UCITS), but these are sent outside the prescribed time frame (up to D+3, not within D+1), which does not comply with the regulations.

Furthermore, in terms of processes, all five institutions have implemented different procedures to inform clients of a fall in the value of their portfolios:

- Manual or automatic reprocessing of client fund withdrawals to correct performance and avoid generating "false alarms";
- Prior verification of potential alerts before informing clients or no prior verification;
- Personalised client alert by telephone followed by email confirmation or automated client alert by SMS, email or post.

Good practices:
- Pre-checking (by the middle office) of the alerts generated, then checking (by asset managers) and then informing clients (by telephone and then by SMS, email or post).
- Indicating in the alert messages the actual percentage fall in value of the portfolio (and not just the threshold crossed).
- Checking with the client that the alerts sent have been successfully received.

Poor practice:
- Sending "false alerts" to clients. Example: When a client withdraws funds (in securities or cash) and this is not analysed and not reprocessed as a withdrawal, which has the effect of artificially degrading the portfolio's performance.

3.5. PROHIBITION ON RETAINING COMMISSION REBATES

In accordance with the provisions of Article L. 533-12-3 of the Monetary and Financial Code, ISPs[10] that provide portfolio management services to third parties may not accept, unless they refund them in full to their clients, any remuneration, commission or other monetary or non-monetary benefits in connection with the service provided to clients, paid or provided by a third party or by a person acting on behalf of a third party.

[10] Including portfolio management companies by reference to Article L. 532-9 VII of the Monetary and Financial Code.

The inspection task force therefore focused on whether the institutions inspected receive any commission rebates in connection with their portfolio management services, on informing their clients about these rebates and, where applicable, on the procedures for refunding all commission rebates to clients.

- Of the institutions inspected, four stated that they no longer receive commission rebates in connection with their portfolio management services. This was confirmed based on an analysis of income from accounting data at 31 December 2018 and 31 March 2019, provided by the institutions to the inspection task force. The analysis shows that there are no further commission rebates accounted for in these two financial statements.

  However, the information provided to clients in the various contractual documents signed by them was incorrect, unclear or contradictory.

  - ✓ For example, several management mandate templates had not yet been updated to comply with the new MiFID 2 provisions and still provided for *"receiving, where permitted by applicable regulations, rebates of management fees from CIUs subscribed to under the mandate"*.
  - ✓ Other documents did not contain any explicit reference to the prohibition on receiving commission rebates other than to refund them in full to clients.
  - ✓ Lastly, some documents (e.g. discretionary mandates, general and specific conditions, fee schedules, ex-post statements of costs and charges) contradicted each other on whether commission rebates were received or not. This was generally due to discrepancies in versions or updates between documents drawn up before 3 January 2018 (MiFID 1) and documents drawn up after that date (MiFID 2).

- Only one institution was still receiving commission rebates. These came from US hedge funds and, in accordance with the new provisions of MiFID 2, were refunded in full to clients, on average within three days, according to the test carried out by the inspection task force. However, the information provided to clients concerning the institution's obligation to refund these commission rebates was unclear in the contractual documentation.

Poor practice:
- Inconsistencies between the various contractual and informational documents provided to clients (discretionary mandates, general and specific conditions, fee schedules, ex-post statements of costs and charges).

Example 1: Stating that the institution may receive commission rebates (e.g. in the ex-post statement of charges) when it no longer receives any.

Example 2: Stating that the institution may receive commission rebates but not specifying, where applicable, that it must refund them in full to its clients.