

# Proposed Conduct of Business Rules for the enhanced protection of customers in investment services

## MFSA RECOMMENDATIONS

### Background

A Conduct of Business (Investment Services) Task Force<sup>1</sup> within MFSA has presented the Board of Governors with proposals (“initial recommendations”) for the review of the current Conduct of Business (“CoB”) regulatory regime in investment services and the definition of appropriate policy changes for the enhanced protection of customers in investment services.

The Board of Governors<sup>2</sup> of the Malta Financial Services Authority (MFSA) has considered this initial report<sup>3</sup> in consultation with other members<sup>4</sup> of the Authority. This paper summarises some of the salient features of these recommendations as approved by the MFSA Board of Governors (“the recommendations”) after this consultation process.

### 1 Desired outcomes, objectives and principles

The UK FSA enumerates six consumer outcomes<sup>5</sup> that are at the basis of the Treating Customers Fairly model (“TCF”) in CoB regulation. They are summarised in Appendix One of this Report. The UK Financial Services and Markets Act 2000<sup>6</sup> also describes the consumers protection objective by having regard to—

- (a) the differing degrees of risk involved in different kinds of investment or other transaction;
- (b) the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;

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<sup>3</sup> Report dated 24<sup>th</sup> September 2013

<sup>4</sup> Dr Marisa Attard, Mr Geoffrey Bezzina, Ms Romina Bonnici, Dr Andre Camilleri, Mr Mike Duignan, Dr David Fabri, Mr David Pullicino, Ms Marianne Scicluna, Ms Pauline Tonna.

<sup>5</sup> Treating customers fairly – towards fair outcomes for consumers – UK FSA July

<sup>6</sup> Article 1C of the UK Financial Services and Markets Act 2000

- (c) the needs that consumers may have for advice and accurate information;
- (d) the general principle that consumers should take responsibility for their decisions;
- (e) the general principle that those providing regulated financial services should provide consumers with a level of care that is appropriate having regard to the degree of risk involved in relation to the investment and the capabilities of the consumers in question;
- (f) the differing expectations that consumers may have in relation to different kinds of investment or other transaction;
- (g) any information which the consumer financial education body has provided to the FCA in the exercise of the consumer financial education function;
- (h) any information which the scheme operator of the ombudsman scheme has provided to the FCA.

In advancing the consumer protection objective, the UK FCA is also required to discharge its functions with due regard to the regulatory principles<sup>7</sup>.

The MFSA agrees that these consumer outcomes, objectives and principles are relevant to the manner in which CoB should be regulated in Malta. There are other outcomes of consumer relevance which are currently regulated and / or supervised by MFSA or other entities within the context of other legislative instruments. Whilst these other outcomes are not meant to form part of the present project for the enhancement of CoB in Malta, the MFSA may at some stage in the future, need to consider their relevance within a more holistic review of conduct of business<sup>8</sup>.

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<sup>7</sup> Articles 1B (5) and 3B of the UK Financial Services and Markets Act 2000:  
 “In relation to the regulators, the regulatory principles referred to in section 1B(5)(a) and 2H(1)(a) are as follows—

- (a) the need to use the resources of each regulator in the most efficient and economic way;
- (b) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- (c) the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term;
- (d) the general principle that consumers should take responsibility for their decisions;
- (e) the responsibilities of the senior management of persons subject to requirements imposed by or under this Act, including those affecting consumers, in relation to compliance with those requirements;
- (f) the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under this Act;
- (g) the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives;
- (h) the principle that the regulators should exercise their functions as transparently as possible.”

<sup>8</sup> The other outcomes which are not included in this project are:

- (i) Expanding access through financial inclusion, thereby requiring firms to give due regard to financial inclusion objectives in the design of their products, services and distribution strategies for unpreferred customer groups;

## 2 Code regulating Conduct of Business

The recommendations<sup>9</sup> require the creation of a single, unified Code regulating Conduct of Business in financial services. The Code, which should have the force of law, should:

- (a) Achieve the desired outcomes, objectives and principles as described in section 1 of these recommendations;
- (b) Achieve consistency: The duty of care to the customer should be the same whether a customer buys, for example, an investment product from a bank or an insurance intermediary. It will therefore be necessary to provide a consistent customer-focused standard of protection for purchasers of financial products and services. The framework must minimise opportunities for regulatory arbitrage between different parts of the financial sector. Therefore the Code would set out the requirements which all financial services providers are required to satisfy when dealing with customers irrespective of the category of providers, and at the same time consolidate the existing disparate CoB regimes applicable to the various financial sectors into a single document. The following additional tools may counteract difficulties inherent in the monitoring and enforcement of entities passporting to Malta under freedom of services: (i) Brussels II Regulations<sup>10</sup>, (ii) the general good provisions – which can be imposed by the host regulator on passporting firms, and (iii) the liaison and reporting procedures between the Regulatory Authorities of Member States.
- (c) Avoid regulatory gaps in the CoB regulation. All financial services providers established in Malta including firms passporting under freedom of establishment and freedom of services should be subject to the same CoB regulation. The Code would equally set out the standards which financial service providers will be required to satisfy when passporting to other jurisdictions.

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<sup>8</sup>(ii) Fair competition outcome: Effective competition works in favour of consumers by providing a wider array of products, services and features at a price which matches consumer demand;

(iii) Compensation schemes;

(iv) Broader market conduct addresses financial markets efficiency and integrity issues, such as disclosures to the market (accounting standards), supervision of trades on securities exchanges, and monitoring of insider trading and market abuse;

(v) Combating financial crime;

(vi) Market risk: It is not the purpose of the current discussion to protect consumers from the possibility of losing money from adverse market movements;

(vii) Investors' mistakes: Nor is it the purpose of the current discussion to protect customers from the possibility of losing money as a result of their mistakes.

<sup>9</sup> Recommendation 15

<sup>10</sup> Council Regulation (EC) No 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters provides that that Regulation shall apply in civil and commercial matters whatever the nature of the court or tribunal.

(d) Regulate differences differently: The recommendations explain that consistency should not mean a “one-size-fits-all”. Whilst the overarching principles will be common, the Code should separately address (under specific headings or chapters) conduct of business requirements currently applicable to specific sectors, customers or products.

(e) Achieve completeness: The recommendations are partly inspired by what has previously gone wrong. They review specific elements of existing investment services regulation that have led to consumer detriment and then provide solutions to these specific problems. This approach is useful in establishing which actions should be given priority. However the transposition of these recommendations to a CoB regulatory framework must not overlook other gaps in existing consumer protection, and the linkages of each recommendation with the overall objectives.

(f) Coordinate sectorial regulation: The CoB regulatory framework should coordinate existing sector-specific financial legislation to reduce the risk of duplication, inconsistencies or gaps in regulation.

(g) Alignment with international requirements: The CoB regulatory framework must also align with international requirements and best practice. However any specific local experience of customer detriment may in exceptional cases justify a different approach to that set out by EU Directives.

### **3 Customer**

TCF is meant to protect ordinary customers who would typically not have the knowledge or expertise to make their own informed decisions. As such, it should not be limited to the protection of individuals but should also ensure fair treatment of sole traders and small and medium enterprises that have similar vulnerabilities.

The recommendations go beyond this and suggest that all customers<sup>11</sup>, without distinction, deserve to be treated fairly – albeit that there should be an enhanced level of protection for specific categories of customers.

This is also how MiFID approaches the subject. Whilst the Directive is intended to protect investors in general, it affords a less rigorous level of consumer protection to professional customers than to retail customers. A professional customer is a person who, as set out in MiFID, possesses the experience, knowledge and expertise to make its own financial decisions and to properly assess the risks it incurs.

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<sup>11</sup> Recommendation 15 (b)

Aside from institutional investors or governmental bodies, a professional customer, in relation to MiFID business, is a large undertaking meeting two of the following size requirements on a company basis:

- (a) balance sheet total of €20,000,000;
- (b) net turnover of €40,000,000;
- (c) own funds of €2,000,000;

The UK and Ireland<sup>12</sup> adopt different baselines for the definition of customer in respect of non-MiFID business.

The recommendations consider that the reasons which justify a different level of protection between retail and professional customers in investment services may be less applicable to insurance and banking services. Therefore the recommendations take the view that as a matter of principle, in respect of non-MiFID business, the financial size of customers (whether retail or professional) should not diminish the extent of CoB protection.

MiFID allows a retail customer to elect to be treated as a professional customer if at least two of the following criteria are satisfied:

- (a) the customer has carried out at least 10 transactions of a significant size per quarter during the previous year;
- (b) the customer's financial instruments portfolio (cash deposits + financial instruments) exceeds €500,000;
- (c) the customer works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the transactions and services envisaged.

Local experience has shown that this option can lead to customer detriment. Therefore the recommendations take the view that a retail customer (of non-MiFID business) should not be allowed to renounce to CoB protection by electing to be treated as a professional customer. A more rigorous approach should likewise be adopted in respect of MiFID business, by making it harder for a retail customer to renounce to CoB protection as a retail customer.

#### **4 Customer under Professional Investor Fund Regime (“PIF”)**

The definition of experienced investor is used in order to target Professional Investor Funds to certain categories of investors. The criteria for classifying an experienced investor under the PIF

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<sup>12</sup> For instance the Irish Consumer Protection Code 2012 applies its General Principles to all customers in Ireland. Customer is defined as any person to whom a regulated entity provides or offers a product or service. However the other chapters of the Code only apply to consumers. Consumers are natural persons, partnerships or small businesses with an annual turnover of less than €3 million. Other chapters in the Code are restricted to personal consumers (= natural persons acting outside their business, trade or profession) or to vulnerable consumers.

regime are less stringent than the criteria applicable to classify a professional customer under MiFID.

The definition would be satisfied if the investor satisfies any one of the following criteria:

- (a) The investor has relevant work experience having at least worked in the financial sector for one year in a professional position or has been active in these types of investments;
- (b) The investor has reasonable experience in the acquisition and/or disposal of funds of a similar nature or risk profile, or property of the same kind as the property, or a substantial part of the property, to which the PIF in question relates;
- (c) The investor has carried out investment transactions in significant size at a certain frequency (carried out transactions within the past two years amounting to at least €50,000 or the equivalent in another currency, at an average frequency of three per quarter).

The minimum investment which a PIF targeted towards experienced investors may accept is €10,000 or \$10,000.

The recommendations acknowledge the usefulness of the experienced investor regime in order to prevent certain categories of investors from having access to PIFs. This is not to say that PIF products were appropriate products for experienced investors in all circumstances. Indeed the recommendations foresee that experienced investors under the PIF regime should continue to benefit from CoB protection available to retail customers.

The recommendations moreover do not advocate a change in the definition of experienced investor for the time being. The focus should be on overarching definitions with more specific definitions being reviewed at a later stage in the CoB review. However in the light of the possible mismatch between the legal definition of “experienced investor” and the common perception of who is truly an experienced investor, the recommendations suggest that the designation might be reviewed.

## 5 Standard of care

The recommendations retain the current three different levels of care which a firm must show its clients, depending on the type of transaction, namely:

- **No care at all**<sup>13</sup> – in promote-and-sell and execution-only transactions, as long as these are executed at the customer’s initiative, and involve non-complex products. But recommendation 4, 5 and 6 removes the promote-and-sell regime; and recommendation 7, 8 and 9 makes it harder for the execution-only regime to be abused.
- **An appropriateness standard of care** – in transactions prompted by a firm as well as in transactions involving complex products whenever the customer does not seek

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Other than in the faithful execution of the customer’s transaction

investment advice. But recommendation 11, 12, 13 and 14 makes it harder for this gateway to be abused.

- **A full know your customer or suitability test<sup>14</sup>** – in advisory transactions.

Whilst retaining these three separate gateways (with their corresponding level of care), the recommendations take the view that any regulatory intervention should ensure that each gateway is not abused<sup>15</sup> and that customers are clearly warned of the provider’s responsibilities in respect of the chosen gateway.

The recommendations recognise that these three separate gateways are at the basis of the MiFID regime and that mandating the suitability test to non-advised transactions<sup>16</sup> would represent a significant departure to current regulation and international best practice.

## 6 Investor protection for locally listed securities

The Listing Committee is debating how to deal with concerns on investor protection where issuers apply for admissibility to listing. Both the Listing Rules and the Prospectus Directive require the Authority to “take account of the different requirements of the protection of the various categories of investors and their level of expertise when approving a prospectus and to ensure that safeguards exist for the protection of the interests of actual and potential investors in order for them to make an informed assessment of such risks and thus to take investment decisions in the full knowledge of the facts.” The Malta Listing Rules implementing various EU Directives reinforce the concept of investor protection by adding that:

“... in order to maintain high standards of disclosure and for investor protection, the Listing Authority may:

1.11.1 require an issuer to provide the Listing Authority for publication ... further information not specified in these listing requirements;

1.11.2 impose, and make admissibility to listing of securities subject to additional requirements, provided that these apply generally for all issuers or for individual classes of issuers.”

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<sup>14</sup> Recommendation 10

<sup>15</sup> Issues requiring regulatory clarity include the definition of “at the initiative of the client” and its antonym (as used in this paper) “sales prompted by a firm”. How would adverts be dealt with? What about cold calling? What about repeat sales of the same product? A firm recommends a bond to a customer under an advisory gateway. The customer buys. The following week the customer phones and requests more of the same. Does this become “at the initiative of the client”? Should documents communicated by a firm to a customer be in dual languages?

<sup>16</sup> Applying the suitability test to non-advised transactions would however ensure that customers get what they need and diminish the potential for mis-selling. It also reduces the opportunity for firms being able to channel sales to a type of transaction that carries the least level of care.

There is therefore an expectation that the Listing Authority should assess both (i) compliance with Listing Rules and (ii) the appropriateness<sup>17</sup> of the proposed security to the target investor. The carrying out of the latter assessment is however challenging because:

- (i) Appropriateness to a target market is a valued judgment which embodies uncertainty on anticipated outcomes. The more complex or intangible the proposal or the more complex the structure of the bond, the more difficult it is for the average investor to understand the investment and consequently its suitability for his portfolio;
- (ii) Low interest rates do not always reflect low risk to the investor: Although there is some correlation, it would be wrong to assume that the bonds' appropriateness for retail customers can be gauged solely by the coupon rate;
- (iii) Requiring that a proposed bond be transacted on an advised basis (ie subject to a test of suitability to the customer), can kill off its liquidity, thus depriving investors of an exit route for their investment; and
- (iv) the application of ad hoc measures (other than disclosure of information) to reinforce investor protection at individual bond issue level is inconsistent with the Listing Rules and CARD, to the extent that additional requirements may only be imposed if these apply generally for all issuers or for individual classes of issuers.

In the light of the above, the recommendations agree with the Listing Committee that, whilst all bonds represent a level of risk which should be well disclosed to customers, certain bonds represent a level of hazard or complexity which mandate their transferability on an advised basis (ie subject to a test of suitability to the customer). However it is the view of MFSA that the application of this broad principle should be further considered by the Listing Committee. Specifically the Listing Committee should determine the classes of bonds<sup>18</sup> to which this principle should apply and whether the test of suitability was equally valid to the primary and secondary market (especially in execution only transactions).

## **7 Product intervention**

MFSA agrees with the initial recommendations<sup>19</sup> that it would be premature to introduce product approval. The arguments set forth in this regard are that a product approved by the Regulator might imply that it cannot fail, thus giving rise to a moral hazard. Moreover, pre-approval of products would require onerous staffing requirements possessing market-oriented expertise. Lack of the

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<sup>17</sup> A useful distinction can be drawn between ensuring a product is appropriate for a particular target market, and ensuring the product is suitable for the particular customer concerned. The former is mainly the product manufacturer's responsibility, and the latter is mainly the provider's responsibility.

<sup>18</sup> The Listing Committee's criteria should where possible achieve consistency with current classification frameworks for complex and non-complex instruments.

<sup>19</sup> Recommendation 37

foregoing would imply considerable delays in products being approved, thus stifling competition and limiting choice for customers.

Whilst product approval is not a tool that is advocated, the recommendations acknowledge that the regulator would need to retain the power to ban the sale to retail customers of complex products of manifest actual or potential consumer detriment as an exceptional measure of last resort<sup>20</sup>. This would require that MFSA should monitor complex products in order to be alert to emerging risks to customers. Moreover the recommendations require that:

- (a) Complex products should carry a warning that they are not suitable for retail investors<sup>21</sup>;
- (b) The sale of such complex products should be through advised distribution channels<sup>22</sup>;
- (c) Qualification requirements should be tightened for advisors dealing in complex products<sup>23</sup>.

## **8 Customer records and disclosures**

The recommendations propose a strengthening of the provisions surrounding customer records.

These include:

- (a) For execution-only transactions, the retention of more comprehensive records showing that the customer acted on his own initiative<sup>24</sup>;
- (b) A statement of compliance and risk disclosure statement signed by the customer as a means of alerting the customer to the type of service and product being purchased and corresponding level of risk. The emphasis here is on ensuring that the customer understands and acknowledges his having been warned of the potential risks when investing in products which do not guarantee a return of capital on maturity<sup>25</sup>;
- (c) All firms should be required to gather information from customers (Client Fact Find) for the purpose of the Suitability or Appropriateness test. The Client Fact Find would determine the reasons why a firm has deemed a particular product to be suitable or appropriate to the customer.
- (d) A Client Fact Find for the purpose of the Suitability or Appropriateness test to be made available to customer<sup>26</sup>.

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<sup>20</sup> Recommendation 41 and 44

<sup>21</sup> Recommendation 40

<sup>22</sup> Recommendation 42

<sup>23</sup> Recommendation 43

<sup>24</sup> Recommendation 7

<sup>25</sup> Recommendation 8

<sup>26</sup> Recommendation 13

- (e) Customer disclosures should be made available, at the customer's request, in the Maltese or English language.

## 9 Professional standards

Apart from deliberate misselling, customers can be missold a financial product because the provider does not fully understand the product in question, or because he does not fully understand the customer's needs. Indeed there is a general view that the entry levels for providers of investment services and for individuals giving advice is too low.

The recommendations therefore suggest raising the competence requirements of investment advisors<sup>27</sup>. The recommendations acknowledge that any such initiative will require the diversion of resources from other areas that may require more immediate attention. MFSA therefore suggests that an analysis should first determine whether recent cases of misselling can be attributed principally to a lack of professional competence. Only if this is the case, should this initiative be undertaken as a matter of priority.

## 10 Capital requirements

MFSA is of the view that raising the capital requirements for holders of category 2 investment licence holders would have no (and at best, a very minimal) effect to the level of customer protection. This is principally because it is not economically feasible to raise capital requirements to the maximum value of potential liabilities.

Nor is MFSA for the time being recommending that relief be provided for misselling by the Investor Compensation Scheme Regulations<sup>28</sup>, because any such extension has a cost factor and would create moral hazard.

## 11 Advisory and non-advisory services

The recommendations<sup>29</sup> propose that the legislative regime governing the distribution of financial products should be reformulated so that it is solely and clearly based on two pillars:

- Advisory services
- Non-Advisory services.

The recommendations suggest that guidance should be issued as to what constitutes an advised sale and a non-advised sale<sup>30</sup>. The presumption should be in favour of an advised transaction. If during a

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<sup>27</sup> Recommendation 16

<sup>28</sup> Directive 97/9/EC does not require the Investor Compensation Scheme to cover civil liability for misselling.

<sup>29</sup> Recommendation 5

<sup>30</sup> Recommendation 6. This should be modelled on the guidance published by CESR

sales process, regardless of the term used to describe it, a seller “places special emphasis on the advantages of one product over others for a customer”, then that process should be considered to be investment advice and therefore subject to the suitability test and to a higher consumer protection level. The grey area currently fostered by the promote-and-sell regime should be abolished<sup>31</sup>. Moreover execution only transactions should not be a default option – possibly allowing such a transaction only in respect of professional clients.

For non-advisory services consisting in execution only transactions, clear warnings should be provided to the customer that he is taking full responsibility for the instructions provided. Conversely there should be clear disclosures of the firm’s level of care for the different categories of advisory services.

## 12 Advisory services

A firm providing advice to customers must describe such advice as either “independent” or “restricted” advice<sup>32</sup>. This will provide customer with clarity as to whether the advice has any strings attached to it.

Independent advisors should satisfy the fair analysis test, as offering access to all products on the market, which may be suitable for a customer. Firms holding themselves to be “independent” advisers should be prohibited<sup>33</sup> from receiving commissions or other benefits from product providers. In such case the firm should disclose its fees to the customer prior to any transaction.

Conversely, a firm that does not advise on the full range of products is providing advice that has been restricted and this advice should be labelled as such. In such case, the firm should clearly disclose to the customer the names of those companies whose products or services it distributes.

## 13 Designations

The recommendations look at improving transparency in relation to financial services provided to customers. The proposed dichotomy between advisory and non-advisory transactions and restricted and independent advice should serve to improve a customer’s understanding of the type of service he will be receiving and the corresponding responsibilities attached to it. Other recommendations relate to the employees who are authorised to provide investment advice. Generic terms or job titles such as Financial Analyst, Financial Advisor, Financial Consultant, Financial Planner, Investment Consultant, Wealth Manager, Securities and Investment officer or Relationship Officer are misleading as they do not clearly reflect the kind of investment service which such officers may

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<sup>31</sup> Recommendation 4

<sup>32</sup> Recommendation 1

<sup>33</sup> Recommendation 17. This is also a MiFID II proposal.

provide. Consequently the recommendations propose a uniform designation<sup>34</sup>. Those authorised to give advice should be designated as investment advisors. Those employees who are not authorised to provide investment advice should be designated as Investment Non-advisors. Moreover MFSA should keep a register<sup>35</sup> with public access (on the MFSA website) containing a list of all individuals who are issued with MFSA's authorisation to provide investment advice and portfolio management.

## 14 Information about products and risk disclosures

The recommendations suggest that product disclosure needs to be improved<sup>36</sup>, and that customers should be provided with sufficient information about products to enable them to make an informed decision<sup>37</sup>. This issue is currently being considered at European level in the context of developments in relation to packaged retail investment products. The final EU Regulation is likely to be in place by the end of 2014, and to become applicable two years after that. In addition, a Key Information Document has been developed for UCITS.

The recommendations<sup>38</sup> also suggest that a horizontal thermometer similar to the one presented by CESR for risk disclosure in the UCITS KID is introduced in the marketing materials for complex products.

However the recommendations<sup>39</sup> propose that the MFSA should await further developments at EU level on the key information document and risk disclosures.

## 15 Inducements

The recommendations propose<sup>40</sup> that there should be the banning of commission and inducements ("commissions") in the case of independent financial advice and discretionary portfolio management. The recommendations reckon that this measure would have limited impact locally since there is only one firm providing independent advice in Malta.

For restricted advisors, the recommendations suggest additional requirements<sup>41</sup> in order to prevent inducements from creating potential conflicts of interest, or from impairing a firm's obligations to

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<sup>34</sup> Recommendation 2

<sup>35</sup> Recommendation 3

<sup>36</sup> First generation client disclosure requirements are imposed in SLC 2.27 and 2.28 of the MFSA Investment Rules for Investment Services Providers.

<sup>37</sup> The Irish Consumer Protection Code 2012 (Chapter 4) already provides detailed requirements for the provision of information to customers on regulatory status and activities of firms, products, charges and remuneration. The UK Conduct of Business Source Book (COBS 13 to 16) contains similar provisions.

<sup>38</sup> Recommendation 38

<sup>39</sup> Recommendation 39

<sup>40</sup> Recommendation 17

<sup>41</sup> Recommendations 18 to 36

act in the best interests of customers. To this end, the recommendations include the following prescriptive requirements:

- (a) Commissions should not be linked to the sale of specific financial instruments or the sale of a specific category of financial instruments<sup>42</sup>.
- (b) There should be an appropriate ratio maintained between variable and fixed remuneration that ensures the best interests of the firm's clients are safeguarded<sup>43</sup>. However the recommendations do not indicate how this ratio is to be determined.
- (c) At least half of the amount paid under variable remuneration should depend on qualitative criteria which would include the following as a minimum: regulatory compliance, internal procedure compliance, fair treatment of clients, and client satisfaction<sup>44</sup>.

The recommendations also suggest that firms adopt the following implementation requirements:

- (a) The firm should maintain continuous Own Risk Assessments to identify riskiness of remuneration policies and ensure compliance with CoB requirements. Controls should include at the very least: monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability, and going through client documentation on a regular basis<sup>45</sup>.
- (b) Persons engaged in control functions should be independent from the business units they oversee and have appropriate authority. They should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business area they control<sup>46</sup>.
- (c) Firms should be required to make disclosures to MFSA of appropriate management information on a regular basis. The gathering of information about what is being sold and by whom is critical in assessing future potential risks that are run by investors. This would enable closer supervision by MFSA of investment firms' conduct risks in a structured manner<sup>47</sup>.

## 16 Remuneration disclosure

The initial recommendations<sup>48</sup> proposed that firms should provide customers with clear, prior disclosure about the existence, nature and amount or method of calculating commissions or other

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<sup>42</sup> Recommendation 27  
<sup>43</sup> Recommendation 28  
<sup>44</sup> Recommendation 29  
<sup>45</sup> Recommendation 30  
<sup>46</sup> Recommendation 32  
<sup>47</sup> Recommendation 36  
<sup>48</sup> Recommendation 25

inducements. In addition, firms should provide their customers with an online inducements calculator. This information should also be disclosed to MFSA.

MFSA is of the view that it should await further developments at EU level before adopting any definitive approach on this matter.

**Monday 27<sup>th</sup> January, 2014**

## **Appendix 1**

### **Treating Customers Fairly**

#### **Outcome 1**

Customers are confident that they are dealing with firms where the fair treatment of customers is central to the firm culture.

TCF is a set of CoB principles and obligations, which are central to Pillar One of the Project; but it is also more than that.

It is a corporate culture which is driven from the top, through commitment from senior management, at all stages of their relationship with the customer, from product design and marketing, through to the advice, point-of-sale and after-sale stages. It should be taken into account when corporate strategy is determined, in the choice of human resources and in approaches to reward within an organisation as well as the front line business areas. Senior management and the board should receive management information that enables them to assess whether customers are being treated fairly. This aspect is sustained through measures devised in Pillar

#### **Outcome 2**

Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.

Products and services need to be designed with the intended market in mind. Equally, it is important they are targeted appropriately, through clear and fair communications to minimise the risks that the marketing might lead those for whom they are unsuitable to buy them.

#### **Outcome 3**

Customers are given clear information and are kept appropriately informed before, during and after the time of contracting.

Clear communication is a key component of firms' approaches to TCF. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading, and this should apply before and at the point of sale.

Firms need to provide clear and fair information to enable customers to make informed decisions about transacting with the firm, its products and services. This means that product risks, commitments, limitations and charges must be transparent. Disclosure around bundled products must enable customers to understand the different components of the bundle.

Post-sale disclosure plays an important role in helping to ensure that customers are kept aware of product performance, their opportunities to act at certain points in the product lifecycle and changes in the terms and conditions.

#### **Outcome 4**

Where customers receive advice, the advice is suitable and takes account of their circumstances. Delivering suitable advice – where a firm has chosen to offer it – is a key component of TCF. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement. Where customers have obtained a recommendation, the advice must reflect their needs, priorities and circumstances. Firms need also to ensure that, where advice is provided, advisers are fully equipped to provide advice.

#### **Outcome 5**

Customers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect.

TCF involves being clear about what product or service is being provided and the range of possible results and experiences for the customer. For products which involve market risk for the buyer, there needs to be clarity about the possible impact of, for example, stock market movements; for general insurance, clarity about exclusions and therefore likelihood of being able to claim. Customers can, of course, be fairly treated even if the product they purchase performs poorly, for example equity market falls can lead to losses; interest rate rises lead to higher mortgage payments; and some insurance claims will fall into exclusions. But there can be fairness issues where the customer is misled about the possible performance of the product. Once acquired, the service level should at least be acceptable (for example, no undue delays) and certainly no different from that actually offered.

#### **Outcome 6**

Customers do not face unreasonable post-sale barriers to change product, switch provider, submit a claim or make a complaint.

The customer ought to be able to change products or switch providers without incurring excessive penalty. Similarly, firms should not make it unnecessarily difficult for customers to make claims or to complain when something goes wrong.

Complaints and claims handling: Firms need to honour representations, assurances and promises that lead to legitimate customer expectations. Legitimate expectations must not be frustrated by unreasonable post-sale barriers. There is a requirement for fair and consistent handling of claims and a mechanism to deal with complaints timeously and fairly. Firms should undertake to identify common underlying causes of complaints and take action to eliminate the root cause.

## Appendix 2

### Conduct of Business Recommendations of Investment Services Task Force

This appendix lists the initial recommendations proposed by a Conduct of Business (Investment Services) Task Force within MFSA. They should be read in conjunction with MFSA's proposals as summarised in the Consultation Document.

#### **Recommendation 1:**

An Investment Services Licence Holder ("ISLH") which holds itself to a client/potential client to be acting 'independently' should satisfy the fair analysis test of providing investment advice based on a fair and comprehensive analysis of investment products available on the market which are suitable based on the client's objectives and needs.

In the interest of transparency and clarity, all types of investors (whether retail or professional) should be directly informed by the ISLH whether the investment advice given is 'independent' or 'restricted' advice regardless also of the type of investment product being offered.

#### **Recommendation 2:**

Employees of ISLHs who are authorised to provide investment advice should be designated as investment advisors. Those employees who are not authorised to provide investment advice should be designated as Investment Non-Advisors.

#### **Recommendation 3:**

It is recommended that the Authority should keep a register to which the public has access (to be published on the MFSA website) containing a list of all individuals within an ISLH who are issued with MFSA's authorisation to provide investment advice and portfolio management.

#### **Recommendation 4:**

It is recommended that the promote and sell regime be removed from the local regulatory framework whilst retaining the practice arising from its definition, that is, giving objective information without making any comment or value judgement on its relevance to decisions which an investor may make.

#### **Recommendation 5:**

The Authority reformulates its local legislative framework so that the latter is solely and clearly based on two pillars:

- Advisory investment services;

- Non-Advisory investment services.

#### **Recommendation 6:**

In the context of the previous recommendation, an additional recommendation is for the Authority to issue guidance to the market on what is deemed by the Regulator to constitute an advised sale and a non-advised sale. This could be achieved by introducing a section in the Guidance Notes to the Investment Services Rules for Investment Services Providers which is modelled on the guidance published by CESR in 2010.

#### **Recommendation 7:**

In respect of each individual transaction completed on an execution only basis, the ISLH be required to:

- (a) justify and demonstrate, through documentary evidence, the manner in which the firm has satisfied itself that the service is being provided at the initiative of the client and to keep a record thereof;
- (b) ask the client to specify the manner, medium or means through which he/she became aware of the specific investment product which is being purchased from the ISLH concerned. It is important here to establish whether the ISLH has made prior contact, whichever the form such contact may take, with the client/potential client in relation to the investment product in question. The answer to such question, together with any supporting documents, should form part of the documentary evidence to be held in terms of paragraph (a) above.

#### **Recommendation 8:**

A Statement of Compliance is applied as a mandatory requirement and is modelled on the same lines as currently applied in the UK. The Statement of Compliance should be looked at as a tool to increase awareness by the client/potential client of the type of service being provided. It should not act, as has been described by the FCA, as a “get out of jail free card”.

#### **Recommendation 9:**

Similar to what has been adopted in the UK, a more straight forward and clear definition of Execution only services is included in our subsidiary legislation which sets out the main concepts of an execution only transaction, namely that it is a transaction executed by an ISLH (a) at the client’s initiative, (b) without the provision of investment advice and (c) where the client takes full responsibility for the instructions provided.

**Recommendation 10:**

A suitability report is introduced as a mandatory requirement for investment firms providing advisory services to retail clients.

**Recommendation 11:**

An appropriateness report should be introduced as a mandatory requirement for investment firms providing non-advisory services to retail clients.

**Recommendation 12:**

The Authority issues guidance on good and best practices concerning the application of the suitability and appropriateness tests, which guidance could include lessons learnt from cases which led to consumer detriment.

**Recommendation 13:**

In respect of the Specimen wording of the Client Fact Find for the Suitability and Appropriateness test, the following is being recommended:

- a) The Guidance Notes should clarify that the templates should be used as a guide on the minimum questions which should be included in the respective tests. An emphasis should be included in the Guidance Notes that additional questions may be included by the ISLH as part of such tests, depending on the type of service, client and complexity of the product.
- b) The option given to the client/potential client in the Specimen wording of the Client Fact Find of not requiring a copy of the Suitability or Appropriateness test is deemed to be a practice which is not in the best interest of the investor. It is therefore recommended that such option be removed from the Specimen wording of the Suitability and Appropriateness tests appended to the Guidance Notes and consequently imposing the mandatory requirement on ISLHs to provide the client with a copy of the respective test/client fact find.

**Recommendation 14:**

It is recommended that the Specimen wording of the Suitability and Appropriateness tests be revised as follows:

- a) A question is introduced under the section relating to education asking specifically about the literacy level of the potential client;
- b) In the Suitability test template, under the section headed 'Investment Objectives, Planning and Risk Profile', it is recommended that the question "What is the investor's attitude towards risk? Low? Medium? High?" should be augmented by requesting the ISLH to explain why such rating

c) Under the section headed 'Assessment of Suitability' and 'Assessment of Appropriateness', the ISLH should not simply answer the question by indicating a 'Yes' or a 'No'. In each case the ISLH should substantiate the answer given to each of these questions by explaining the reason for such answer.

d) In order to prompt the provision of such information, it is recommended that the format of such section for both tests be amended as follows so as to avoid that such tests be used merely as a tick-box exercise:

**Recommendation 15:**

It is recommended that the Authority establishes a single, unified Conduct of Business Code which sets out the requirements which all financial services providers are required to satisfy when dealing with clients irrespective of the category of providers.

The Code should be applicable to:

- (a) all financial services providers, including persons exercising their right to passport into Malta via freedom of establishment or freedom to provide services;
- (b) both retail and professional clients.

That said, the objective is not a 'one-size-fits-all' Code. The Code should separately address (under specific headings or chapters) conduct of business requirements currently applicable to a specific sector, client or product.

The initial phase of constructing the Code should primarily focus on consolidating the existing legal instruments into a single document. The project should then seek to encompass new conduct of business practices driven by domestic experiences and EU legislation such as MiFID 2, IMD 2 and Solvency II.

The Code should be considered as a living document, updated to reflect new emerging practices, experiences and legislative developments.

Consultation with the industry, associations and other stakeholders should be undertaken in the development of such a Code so as to ensure a consistent understanding of the overriding objective of the Code, which is, having a strong, unified Conduct of Business framework.

**Recommendation 16:**

It is recommended that the Authority establishes a Code on Minimum Competency which:

- (i) sets out the minimum level of knowledge and competence required for each category of financial services providers;
- (ii) introduces the concept of continuing professional development (CPD);

(iii) encompasses professional and ethical standards on how to take the interests of the consumer into account at all times.

The Code should be applicable to all financial services providers, excluding persons exercising their right to passport into Malta via freedom of establishment or freedom to provide services (in view of the mutual recognition concept).

The initial phase of constructing the Code should primarily focus on consolidating the existing requirements into a single document. The project should then seek to assess the need of upgrading existing knowledge requirements and address developments occurring both in the local market and also at EU level through legislation such as IMD 2 and Solvency II.

Consultation with academic and educational bodies should be undertaken in the development of such Code.

This recommendation should be read in conjunction with recommendation 43.

**Recommendation 17:**

Following from the European Commission MiFID II proposal, there should be the banning of commission and inducements in the case of independent financial advice and discretionary portfolio management.

**Recommendation 18:**

There should be the setting up of specific arrangements and internal procedures by investment firms devoted to MiFID inducement rules. The systems should enable the firms to identify, classify and evaluate all types of fees, commissions and non-monetary benefits prior to the provision of any investment or ancillary service to their clients. The investment firm's policies and procedures to be followed when assessing the legitimacy of the payments and non-monetary benefits should include the basis for the decision/evaluation process.

**Recommendation 19:**

Any type of payment or non-monetary benefit falling under Article 26(b) of the Level 2 Directive (an inter-firm commission) should be assessed to ensure that it is designed to enhance the quality of the service while not impairing compliance with the firm's duty to act in the best interests of the client. In addition, the client should be given clear prior disclosure.

**Recommendation 20:**

An investment firm can only consider a given payment as a fee if the payment is necessary for the service and if it cannot give rise to conflicts of interest between the firm and its clients.

**Recommendation 21:**

Senior management, or where appropriate the supervisory function, after taking advice from the compliance function, should approve the general policy to be applied by the investment firm to inducements and approve the design of remuneration policies and practices. Inducements and remuneration policy should be key areas in compliance function activities. These would then be implemented by appropriate functions to promote effective corporate governance. Responsibility for the implementation should rest with senior management.

**Recommendation 22**

Suitability tests should be strong enough to ensure that their objective is effectively met, such that investment products sold to clients are suitable for them. Appropriate conflicts of interest management and controls by the compliance function should be in place to ensure that the investment advice provided is not biased.

**Recommendation 23:**

The remuneration of sales staff and advisors should be structured in a manner that avoids creating an incentive to recommend investment products with the highest commission for the investment firm and/or the highest rewards for the sales staff.

**Recommendation 24:**

Rebates on fees such as brokerage and custody fees should only be allowed in the case where the firm's duty to act in the client's best interests is not impaired. In addition, rebates on fees should only be used by the investment firm to reduce the fees payable by its clients.

**Recommendation 25:**

Investment firms should provide clients with clear, prior disclosure about the existence, nature and amount or method of calculating that amount of the different inducements payable/receivable. Inducements should be classified by in-group and other investment firms, and by whether it is one-off or ongoing. Inducements should be split between monetary and non-monetary ones, and between the different categories of investment and ancillary services to which they relate. In addition, investment firms should provide their clients with an online inducements calculator. This information should be maintained by the investment firm internally and updated as necessary, with submission to the MFSA made once every year.

**Recommendation 26:**

Investment firms should have specific arrangements and procedures to ensure a prompt and appropriate treatment of client requests regarding inducements, with a specific person responsible. Procedures should embed arrangements for the keeping of records of information disclosed to clients regarding inducements.

**Recommendation 27:**

Remuneration should not be linked to the sale of specific financial instruments or the sale of a specific category of financial instruments.

**Recommendation 28:**

There should be an appropriate ratio maintained by the investment firm between variable and fixed remuneration that ensures the best interests of the firm's clients are safeguarded. Furthermore, there should be the possibility to pay no variable remuneration at all.

**Recommendation 29:**

At least half of the amount paid under variable remuneration should depend on qualitative criteria which would include the following as a minimum; regulatory compliance, internal procedure compliance, fair treatment of clients, and client satisfaction.

**Recommendation 30:**

Adequate and appropriate controls should be set up and maintained by investment firms to ensure compliance with their remuneration policies and practices. The controls should be applied throughout the firm and be subject to periodic review. Controls should include at the very least; monitoring calls for telephone sales, sampling of advice and client portfolios provided to check suitability, and going through client documentation on a regular basis.

**Recommendation 31:**

Appropriate and transparent reporting lines should be in place across the investment firm or group to assist in escalating issues involving risks of non-compliance with MiFID conflicts of interest and conduct of business requirements.

**Recommendation 32:**

Persons engaged in control functions should be independent from the business units they oversee and have appropriate authority. They should be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business area they control.

**Recommendation 33:**

The receipt of inducements on a recurrent basis by intermediaries providing financial advice requires that the intermediary keep the situation of the clients and financial instruments under review to confirm the continued suitability of the investments.

**Recommendation 34:**

The recommendations made in this report, which aim towards reducing the reliance on commissions in the Maltese financial sector, should be issued while leaving the market to operate freely in selecting the level of reliance on advisory fees and the specified level of advisory fees to be charged. However, the Authority should monitor developments in the market through the collection of the relevant data, with the objective of studying financial industry competition. The relevant recommendations from that study could then be made so that the operation of the free market is fostered, in a manner that contributes towards productive and allocative efficiency.

**Recommendation 35:**

The MFSA should conduct appropriate consultations to assess the potential impact of the proposed changes on inducements.

**Recommendation 36:**

The Authority should study the appropriate data that would need to be gathered on a regular basis, which would enable closer supervision of investment firms' conduct of business in a structured manner.

**Recommendation 37:**

It is recommended that the MFSA should not engage in pre-approving investment products.

The arguments set forth both by the FSA in the United Kingdom and by senior officials within the MFSA in this regard are that a product "approved" by the regulator might imply that it cannot fail, thus giving rise to moral hazard.

Moreover, pre-approving of products would require onerous staffing requirements possessing market-oriented expertise. Lack of the foregoing would imply considerable delays in products being approved, thus stifling competition and limiting choice for consumers.

**Recommendation 38:**

It is recommended that a horizontal thermometer similar to the one presented by CESR for risk disclosure in the UCITS' KID is introduced in the marketing materials for highly complex structured financial instruments with a high risk of mis-selling. The onus would be on the product provider to "grade" the risk of the particular investment product. However, it would be important to ensure that consistent pictorial representation of risk was underpinned by a consistent methodology for the calculation of the risk level of different funds to ensure accurate benchmarking. Such consistent methodology might be outlined in the form of a rule published by the MFSA requiring authorised undertakings to take specified steps in connection with the setting of benchmarks.

**Recommendation 39:**

Presenting information pertaining to investment products in a short standardised format - such as a Key Information Document - would prove to be beneficial to the retail consumer in assessing the relative risks of the different investment options available. It is however recommended to await further developments at EU level on the Key Information Document and its applicability.

**Recommendation 40:**

It is recommended that the MFSA implements a similar approach as is implemented in France – and is being proposed in the United Kingdom – for products with highly complex structured financial instruments with a high risk of mis-selling to carry a warning that the MFSA considers such products as being too complex to be marketed to retail investors. Alternatively, the MFSA could publish a list of products that are regarded as being generally unsuitable for the mainstream, retail market.

**Recommendation 41:**

Specific investments, which are particularly complicated, should only be permitted to be sold to professional clients.

**Recommendation 42:**

The MFSA should consider the appropriateness of requiring that investment products that are particularly complicated, or where there is a high risk of consumer detriment, should only be sold using advised distribution channels.

**Recommendation 43:**

The MFSA should consider imposing more specialist qualification requirements for advisors advising on non-mainstream products.

**Recommendation 44:**

The MFSA might consider banning products or banning product features to be sold to retail investors, when such products have the potential to cause significant consumer detriment but only as a measure of the last resort, since it is likely that products that are not banned will be perceived by consumers as having been approved for sale by the regulator.

**24<sup>th</sup> September 2013**