

## Response to ESMA's Consultation on Certain Aspects of the MiFID II Suitability Requirements

**Question 2: Do you agree with the suggested approach on the arrangements necessary to understand clients and specifically with how the guideline has been updated to take into account behavioural finance and the development of robo-advice models?**

**Question 7: Do you agree with the suggested approach on to the arrangements necessary to understand investment products for the purposes of suitability assessment? Please also state the reasons for your answer.**

We believe that the suggested approach on the arrangements necessary to understand clients and products should reflect the increasing research showing that non-financial interests of clients are not properly ascertained, as well as the research showing that retail investors are increasingly concerned about their money being invested in ways that align with their non-financial interests.

This consideration is animated by the work of the High Level Expert Group on Sustainable Finance, and relates closely to the recommendation for the incorporation of environmental, social and governance concerns in the legal duties of market actors across the investment chain.<sup>1</sup>

### **Understanding the interest of the client**

Evidence supports that retail investors are increasingly interested in ensuring their investment decisions do more than provide maximum return. Increasingly, investors recognize a non-financial dimension to their interest vis-à-vis the use of their money. Research pointing to this conclusion includes:

- A 2017 White Paper by Morgan Stanley, which concluded that: 75% of the retail investors interviewed are interested in sustainable investing. The figure is 86% when those investors are millennials, 71% believe that companies with leading sustainability practices may be better long-term investments, 80% are interested in sustainable investments that may be customized to meet their interests and goals.<sup>2</sup>
- A 2017 study by Ernst and Young, which concluded that wealth and asset managers have seen as significant influx of client funds flow into sustainable investments. This asset class has grown by 104.6% annually since 2012 and currently accounts for 18% of the assets under management in US wealth and asset management – driven by demands of millennial retail investors. Fund managers are thus contributing increasing resources to ensure they

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<sup>1</sup> [https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf)

<sup>2</sup> [http://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable\\_Signals\\_Whitepaper.pdf](http://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf)

develop products and capture this emerging client segment. In more detail: 29% of investors in their 20s and 30s seek a financial advisor who provides values-based investing options.<sup>3</sup>

- A 2016 study by Schroders Asset Management, which showed that the importance attached to environmental, social and governance factors on behalf of consumers is not matched by similar importance in the advisers' decision-making when recommending products. The biggest disconnect between consumers and their advisers has been noted in the UK, the US, Singapore, Germany and Italy.<sup>4</sup>
  
- A 2017 survey by Natixis Asset Management, in which it was shown that among over 7000 respondents in 22 countries, 70% of retail investors consider non-financial factors as important in their decision-making.<sup>5</sup>

This research points to the fact that the interest of the client is intimately connected to both financial and non-financial concerns, as those relate to responsible investment – investment characterized by a due consideration of environmental, social and governance factors in the investment decision-making process.

Article 24 of MiFID 2 clearly requires investment firms to “act honestly, fairly and professionally in accordance with the best interests of its clients”, as such, a holistic approach to ascertaining the best interest of the client (including financial and non-financial considerations) should be undertaken on behalf of firms falling under the scope of the regulation. Without the development of guidance to incorporate this approach, it is unlikely that firms would be able to provide suitable personal recommendations to their clients or make suitable investment decisions on behalf of their clients.

### **Defining financial and non-financial interests**

In order to properly ascertain these interests, it is important to discuss what non-financial and financial interests mean. The UK Law Commission's 2014 review, “Fiduciary Duties of Investment Intermediaries”<sup>6</sup>, has proposed a distinction, adapted below to fit the scope of MiFID II:

- **Financial interests:** Any factor which is relevant to the firm's duty of balancing returns against risks. This includes the consideration of environmental, social, and governance indicators, since those are often linked to the long-term health of the investment, i.e., when the end investee entity is characterized by poor governance and contributes to environmental degradation, or risks being liable to damage in reputation or liable for civil or criminal liability.
- **Non-financial interests:** factors which might influence decisions motivated by non-financial concerns, such as by:
  - 1) improving the quality of life of the client by allowing them to live in a clean and safe planet.

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<sup>3</sup> [http://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/\\$FILE/ey-sustainable-investing-the-millennial-investor.pdf](http://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/$FILE/ey-sustainable-investing-the-millennial-investor.pdf)

<sup>4</sup> <http://www.schroders.com/en/insights/global-investor-study/2016findings/>

<sup>5</sup> <https://ngam.natixis.com/us/resources/mind-shift-getting-past-the-screens-of-responsible-investing>

<sup>6</sup> [http://www.lawcom.gov.uk/app/uploads/2015/03/lc350\\_fiduciary\\_duties.pdf](http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf)

- 2) disapproving of unethical conduct: this may include disinvestment from investee entities which engage in alcohol, tobacco and armament production.

It is important to note that environmental, social and governance factors are not purely financial or purely non-financial factors and cannot be fit exclusively into either category. The determination of which category they fall under lies with the assessment of the risk to the performance of the product. For example, it is possible that a product be linked to financial liability though its connection to an investee entity involved in the production of armaments (such as through reputational risks, etc) – in this case, the risk is financial. It is also possible that the liabilities connected to a product linked to an entity investing in the production of armaments may not have a direct discernable financial link – but rather have pose a non-financial risk through ethical concerns about investing in such entities.

In order for a firm to be able to fully assess the how their product is influenced by (financial dimension) and influences (non-financial dimension) environmental, social and governance concerns, it is important to take a proactive stance in approaching sustainability concerns of clients. This would imply that products whose stated purpose is the pursuit of an environmental and/or social objective are one part of the equation, but that products without this stated purpose should also be encouraged to assess their impact on environmental, social and governance factors and ascertain the financial and non-financial interests of their clients as those relate to these factors.

### **Gaps in practice under MiFID II**

In order to ensure that Europe play a leading role in spearheading the transition to a sustainable financial system, in which a significant segment of capital is allocated to long-term investments which will help ensure the creation of long-term job opportunities, inclusive growth and healthy competitiveness, investment firms should be able to provide product options that are customizable to the financial and non-financial interests of the client, as those relate to environmental, social and governance factors. This is becoming increasingly significant in the context of millennial retail investors.

Current practice under MiFID II is not consistent with ensuring the work of the High Level Expert Group reach scale and that retail investors be encouraged to contribute to the transition to a sustainable financial system:

- A 2017 survey by ShareAction mapped the responsible investment practices by the 40 biggest European asset managers showed that improvement in communication and accountability to clients is still badly needed: 17% of survey respondents provide no information on environmental and/or social factors either to clients or in publicly available reporting. Additionally, only 5% of managers provide detailed information, including quantitative information, on the impacts of their investments, and the information provided generally covers areas such as greenhouse gas emissions, water use, waste generation and energy consumption.<sup>7</sup>
- A 2017 study by 2 Degrees Investing Initiative analyzes current profiling practices and questionnaires used in Europe, and has indicated that the non-financial interests of clients do not currently form part of the consultation with the client and the process of ascertaining their interests.<sup>8</sup>

We believe that the use of robo-advisers needs to be capitalized on in order to bridge this misalignment. In the US context, the use of robo-advisers for sustainable investing is influenced by two main factors,

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<sup>7</sup> <https://shareaction.org/wp-content/uploads/2017/03/Survey-LiftingTheLid.pdf>

<sup>8</sup> [http://2degrees-investing.org/IMG/pdf/retail\\_savings\\_final.pdf](http://2degrees-investing.org/IMG/pdf/retail_savings_final.pdf)

according to an article<sup>9</sup> by Business Insider, which reiterates some of the points of the aforementioned research:

- *Sustainable investments make up 28% of all global assets under management (AUM), making it an enormous market. Global sustainable investment reached £14 trillion (\$21.4 trillion) in 2014, according to the Global Sustainable Investment Association (GSIA). Total global AUM reached £51 trillion (\$74 trillion). Meanwhile, BI Intelligence forecasts that robo-advisers will be managing £6 trillion (\$8 trillion) globally by 2020 — if 28% of this were sustainable, it would equate to a market of £1.4 trillion (\$2 trillion).*
- *It particularly appeals to a key demographic — millennials. This group is notoriously much less likely to invest as a whole, but sustainable investment products could draw them in — 67% of millennials want their investments to reflect their social, political, and environmental values. This compares to 44% of Generation X and 36% of baby boomers, according to US Trust.*

An innovation in this field is the San Francisco-based application Grow<sup>10</sup>, which provides automated investment advice, but only for investments that meet specific ethical criteria such as social, environmental, or political impact, in addition to considering monetary return.

This kind of technology will play a very significant role in the transition to a sustainable financial system and we fully support their use in allowing retail investors to invest responsibly, in accordance to their financial and non-financial interests.

### **The role of the European Supervisory Authorities (ESAs)**

The ESAs have a significant role to play in mitigating the aforementioned misalignment between client and investment firm. The Interim Report of the High Level Expert Group on Sustainable Finance has noted that sustainable finance considerations must be increasingly incorporated in financial supervision, in particular that:

- *“The ESAs address sustainability issues within their existing objectives. In particular, they could develop common guidelines and supervisory convergence on ESG disclosure by investors and lenders at the EU level, creating a level playing field across borders and investor categories (pension funds, insurance, mutual funds, asset managers, banks and banks’ clients). This could be linked to the Non-Financial Reporting Directive and its 2017 guidelines, with the aim of improving ESG-related data to feed into risk assessment processes.*
- *The ESAs encourage a certain percentage of representatives in stakeholder groups to have expertise on sustainability issues in the financial sector.*
- *The ESAs play a role in facilitating general coordination between competent authorities on sustainability issues, as already set out in ESA regulations.”<sup>11</sup>*

On September 20<sup>th</sup>, the European Commission released COM (2017) 542 in which a new vision was set for the role of the ESAs in the transition to a sustainable financial system:

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<sup>9</sup> <http://uk.businessinsider.com/robo-advisor-grow-targets-sustainable-investments-2016-10?r=US&IR=T>

<sup>10</sup> <http://investwithgrow.com/>

<sup>11</sup> [https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf)

*“..the European Supervisory Authorities can play an important role in creating a regulatory and supervisory framework that supports mobilizing and orienting private capital flows towards sustainable investments while ensuring financial stability. (...)As a first step towards a more comprehensive strategy, the proposals accompanying this Communication specifically require the European Supervisory Authorities to take into account of to environmental, social and governance factors arising within the framework of their mandate. For example, this will enable the Authorities to monitor how financial institutions identify, report, and address environmental, social and governance risks, thereby enhancing financial viability and stability. The European Supervisory Authorities can also provide guidance on how sustainability considerations can be effectively embodied in relevant EU financial legislation, and promote coherent implementation of such rules upon adoption.”<sup>12</sup>*

Notwithstanding the aforementioned policy direction, we would like to emphasize that the duty to best ascertain the financial and non-financial interests of the client, coupled with the offer of products customizable to said interest, fall under the current mandate of the ESAs to ensure the highest level of consumer protection.

### **Recommendations**

Needless to say, investment firms are complex entities and the diversity of their governance structures (as well as the diversity of their client base) would require careful deliberation and planning on how the aforementioned non-financial interests can be incorporated in the design of financial products and overall investment strategy. Nonetheless, first steps need to be made towards this direction.

As such, we recommend that ESMA ensure the following:

- Questionnaires to clients should include elements that clearly enquire on both the financial and non-financial interests of clients, as those relate to environmental, social and governance indicators.
- Questionnaires should include examples on what both these categories include provided, as a matter of allowing the client to choose according to his/her financial situation and investment objectives.
- All products should include information on how their performance influences and is influenced by environmental, social and governance factors. This should cover firms whose purpose is to deliver on an environmental or social objective, as well as those who do not have this stated purpose.
- Ensure that internal governance structures of investment firms facilitate the ascertaining of the aforementioned interest, such as by the provision of in-house expertise on environmental, social and governance issues and representation of clients in said structure. Barring in-house expertise, it is likely that external investment research will be provided to deliver on the aforementioned objectives, which we believe should not be an excess cost burden on the client: this research forms part of the basic duty of care that is owed to that client in determining his/her best interest holistically, consistently and with utmost professionalism.

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<sup>12</sup> [http://ec.europa.eu/finance/docs/law/170920-communication-esas\\_en.pdf](http://ec.europa.eu/finance/docs/law/170920-communication-esas_en.pdf)

