Response to ESMA consultation

Guidelines on certain aspects of the MiFID II suitability requirements

RESPONSE TO THE CONSULTATION

Dear Sir, dear Madam,

The High-Level Expert Group on sustainable finance (HLEG) is pleased to have the opportunity to provide input on the ESMA's consultation regarding *guidelines on certain aspects of the Mifid II suitability requirements.*

The response from the HLEG focuses on the consideration of clients' *non-financial* investment objectives in the suitability assessments, including expectations related to the social and environmental impacts associated with the management of investment products as well as the use of shareholder rights to support social and environmental outcomes.

The recommendations presented below are part of the broader considerations of the HLEG regarding i) sustainability and the role of the ESAs, and ii) the mobilisation of retail investors to support the EU's sustainability goals.

This response also builds on the set of proposals adopted by the European Commission in September 2017 regarding the role of ESAs (ESA Package):

- *"It is therefore crucial that the financial system plays its full part in meeting critical sustainability challenges. This will require a deep re-engineering of the financial system to which the ESAs should make an active contribution starting with reforms to create the right regulatory and supervisory framework to mobilise and orient private capital flows towards sustainable investments."* (Recital 8)
- *"The ESAs should provide guidance on how sustainability considerations can be effectively embodied in relevant EU financial legislation, and promote coherent implementation of these provisions upon adoption."* (Recital 9)

The members of the HLEG stand ready to provide more details on their recommendations and the related background material.

Yours sincerely,

The chairman

Q2: 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?

1) OMISSION OF NON-FINANCIAL OBJECTIVES IN QUESTIONNAIRES

Risk of systematic behavioural bias. The HLEG response focuses on the omission of questions related to the 'non-financial objectives' of the client in the context of suitability assessment:

- Various surveys of EU retail investors suggest that about 70-80% of them view 'non-financial' factors (i.e. environmental, social, ethical impacts associated with their investments) as important factors for their investment decision-making (see Annex 1). The level of interest is specifically high for the younger generations (more exposed to robo-advice), who are more exposed to automated investing processes, and female investors.
- In contrast, a research paper analysing the suitability assessment questionnaires used across Europe suggests that no question is included on non-financial objectives and preferences (see Annex 2).

This omission creates a risk of behavioural bias related to « frame dependence and anchoring »: most clients do not share their expectations spontaneously if they perceive that it is not part of the process. Advisers are not asking about non-financial factors because clients are not emphasising their importance, and clients are not mentioning them because they are not asked.

The lack of question(s) on non-financial objectives in the suitability assessment questionnaires also prevent the communication of client's expectations to asset managers to inform product design.

Moreover, as sustainability is closely linked to a long-term perspective, it is essential to put upfront a question about the client's time horizon in investing. This is crucial also to frame the risk-return tradeoff.

Last but not least, expectations expressed by clients are, in most cases, not recorded by advisors (since the questionnaire does not include related fields), thus preventing an internal or external audit to identify the concern.

The analysis of the MiFID regulation, the supporting guidelines, and the transposition into national regulation in key member states show that this issue is currently not addressed (see Annex 2). Every regulatory document seems to suggest that non-financial objectives can be ignored and the documents seem to be interpreted this way by market players (see Annex 2). However, this interpretation is misaligned with the core purpose of MFID. The MIFID requirement is to find out essential facts about the client to determine their investment objectives. We believe this should include establishing their attitude to the non-financial factors and the extent to which the client wants them reflected in the recommendation that they receive. As the suitability of the recommendation to the client objective links to an adviser (or portfolio manager) being liable for delivery of suitable advice (or investment services) then making an assumption that the non-financial factors are not important to the client should not be an acceptable discharge of the duty to assess suitability.

This also follows through to MS supervisors. The know your client obligations from MIFID in the UK FCA's COBS sourcebook (5.2) say that to ensure suitability of advice, sufficient information must be obtained about the customer to allow the adviser to act in a way that is suitable for the client.

Omission justified by questionable assumptions. When asked about this issue in the context of the aforementioned research, some market players and national supervisors suggested that the non-financial expectations of retail investors might be exaggerated by the surveys. The underlying assumption is that retail investors are interested in contributing to better social and environmental outcomes with their investments, but not ready to accept the necessary trade-offs in terms of expected returns, risk exposure and liquidity constraints. These limitations are, in the views of the interviewees, the main factors explaining the limited penetration of sustainable investment products.

Indeed, to support this point, consumer surveys often do not explore the willingness to accept trade-offs. Equally, to our knowledge, no research has been produced on the topic that would substantiate the assumptions of the market players and regulators interviewed.

Furthermore, the assumption that integrating 'non-financial' criteria necessarily implies trade-offs on returns, risk exposure and liquidity constraints is questionable and not substantiated:

- Whilst it is logically possible to argue that narrowing down the choice through social, environmental or ethical filters can reduce returns, this argument of limited relevance in the context of retail investment products marketing, in which advisors usually narrow down the universe to a selection of products and certain markets for internal process related reasons, without assessing the implications on returns or reporting the issue to their clients.
- Furthermore there is a growing body of research that suggest that asset prices, specifically on stock markets are driven by short term trading and thus underweight long-term risk factors[1], notably those related to social and environmental issues. The integration of social, environmental and governance related criteria could then help correct this bias. The review of academic studies indeed suggests a positive correlation between the integration of ESG factors and performance[2].

Recommendations of the HLEG. To shift the burden of proof, the **HLEG recommends the ESMA**:

a) **conduct surveys and focus groups** to better understand the level of interest of European retail investors and their willingness to accept trade-offs,
b) **conduct market studies** to better understand how various types of sustainable investment products are associated (or not) with trade-offs.
c) **produce technical guidance** on the types of questions that could be integrated in suitability assessment questionnaires, building on the findings of a) and b).

[1] See All Swans Are Black in the Dark (2Dii/Generation 2017), The Long and Winding Road (Mercer/2Dii/Generation).
[2] Demystifying Responsible Investment Performance. A review of key academic and broker research on ESG factors (UNEP/Mercer 2007).

As a first step, **the HLEG recommends that the ESMA update the guidelines on suitability requirements to explicitly include general provisions regarding the obligation to ask clients about their non-financial investment objectives and to follow up if the client is interested in these objectives**. It should be the case that a suitability assessment would not be compliant without the factors being at least raised. For illustrative purposes, suggested amendments to the guidelines are presented in Annex 3.

2) IMPLICATIONS OF THE DEVELOPMENT OF ROBO-ADVICE MODELS

Process today. Today, most suitability assessment questionnaires are designed to be used in the context of an in-person meeting with a financial advisor. The number of questions are usually limited to around 20 questions and the structure is linear (e.g. limited use of optional questions dependent on the answers from other questions). The responses to these questions are used by the advisor to classify the client in a category (usually one of 4 to 5 categories) and then recommend of a short list of eligible products. This process is likely to be disrupted by robo-advice going forward, however.

Process tomorrow. With the increasing substitution of robo-advice for traditional financial advisors, the suitability assessment process is likely to evolve:

- The shift to online questionnaires will enable a more sophisticated structure of questions, while not increasing the complexity nor the duration of assessments. For instance, if the client responds positively to a question about his/her willingness to pursue social or environmental objectives, an online questionnaire can trigger another question asking for details.

Moreover, even if the penetration of robo-advice among retail investors remains limited in the next few years, the use of similar robo-advisors by financial advisors as a tool to help them during client meetings is likely to take off.

Recommendations of the HLEG. In line with the package of proposals adopted by the European Commission in September 2017 that requires supervisors to *"gain knowledge from working with innovative firms and learn about new technologies and business models,"* the **HLEG recommends that ESMA to reach out to robo-advice companies that seek to integrate non-financial questions into their suitability assessments** and product selection functions in order to support the development of best practices that can then be turned into guidance tailored for web-based questionnaires and product scanners.

Q7: Do you agree with the suggested approach on to the arrangements necessary to understand investment products for the purposes of suitability assessment?

Know the ESG features of your product. The HLEG welcomes the expansion of the 'know your product' aspects of the suitability assessment, especially the requirement to have the *"procedures, methodologies and tools in place to understand the complexity features"* of the investment products, and the guideline to "*not solely rely on data providers*" but also "*check and challenge such data or compare data provided by multiple sources of information*."

In line with the recommendations made for Q2, the **HLEG recommends that the ESMA explicitly mention in the guidelines that these obligations apply to social and environmental features** of investment products (e.g. exposure to controversial activities from a sustainability perspective, use of voting rights regarding social and environmental aspects, etc).

The potential of 'product scanners'. In the current environment, significant improvement in the knowledge of financial advisors about the social and environmental complexity features of a large range of investment products is unlikely to take place: the Key Information Document of most products do not include any information about these topics and the training of financial advisors do not allow them to overcome this gap. However, as discussed above, the likely evolution of questionnaires and product selection processes towards web-based questionnaires and 'product scanners' will enable a much more sophisticated approach.

Concretely, a number of labelling schemes for funds (e.g. Climatrics rating by CDP, Sustainability Ratings for funds by Morningstar – see Annex 4) have been recently introduced. Besides, when the composition of funds is available, in most cases it is possible to use multiple sources of social and environmental information on securities to assess the exposure of funds to various business activities and issues. The information currently available in combination with 'product scanners' therefore allow retailers to associate each product with its sustainability features and match them with the clients' social and environmental criteria.

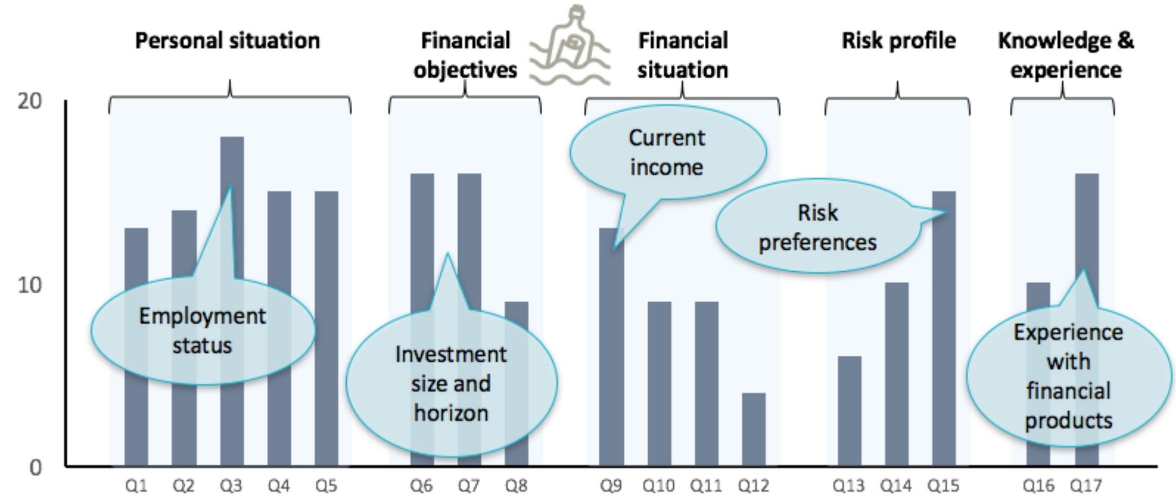
ANNEXES

ANNEX 1 – RETAIL INVESTORS SURVEYS ON SUSTAINABILITY

- A survey of over 7000 respondents in 22 countries by Natixis Global Asset Management in 2017 finds that social and environmental objectives are an important factor for around 70% of retail investors (Mind shift - Getting past the screens of responsible investing).
- A similar survey from Schroders (Global perspectives on sustainable investing 2017), surveying 22,100 active retail investors from 30 countries in June 2017 finds that 78% feel sustainable investing is more important to then now compared to five years ago.

ANNEX 2 – ANALYSIS OF SUITABILITY ASSESSMENT QUESTIONNAIRES AND RELATED REGULATION

Common questions featured in investment client profiling questionnaires: non-financial investment objectives are missing



Number of questionnaires (out of 19 in total) that included the question

Survey based on 19 questionnaires from mainstream retailers in five EU countries (UK, France, Germany, Italy, Spain).

MiFID II does not specify if non-financial investment objectives should be discussed

Level 1 Legislation	MiFID II Directive 2014/65/EU	Article 25-2 on Assessment of suitability and appropriateness: When providing investment advice (...) the investment firm shall obtain the necessary information regarding the client's (...) knowledge and experience in the investment field relevant to the specific type of product (...), that person's financial situation including his/her ability to bear losses, and **his/her investment objectives including his/her risk tolerance** so as to enable the investment firm to recommend to the client (...) **the investment services and financial instruments that are suitable for him** and, in particular, are in accordance with his/her risk tolerance and ability to bear losses.
Level 2 Regulation	Delegated Regulation (EU) 2017/565	Article 54-2 on Assessment of suitability and suitability reports: Investment firms shall obtain from clients or potential clients such information as is necessary for the firm **to understand the essential facts about the client** and to have a reasonable basis for determining (...) that the specific transaction to be recommended (...) satisfies the following criteria: a) it meets the investment objectives of the client in question, **including client's risk tolerance**; b) it is such that the client is able financially to **bear** any related **investment risks consistent** with his/her **investment objectives**; c) it is such that the client has the necessary experience and knowledge in order to **understand the risks** involved in the transaction (...)

Source: **Non-financial message in a bottle** - How the environmental objectives of retail investors are overlooked in mifid ii – priips implementation (2Dii, 2017)

ANNEX 3 – POTENTIAL AMENDMENT TO THE GUIDELINES

For illustrative purposes, the text in blue below provides an example of how the guidelines can be amended to include the obligation to understand the non-financial objectives of the clients.

"Arrangements necessary to understand clients (…)

Supporting guidelines (…)

26. Information necessary to conduct a suitability assessment includes different elements that may affect, for example, the analysis of the client's financial situation (including his/her ability to bear losses) or investment objectives (financial objectives including his/her risk tolerance, as well as non-financial objectives). Examples of such elements are the client's:
    a) Marital status (…);
    b) family situation (…);
    c) age (…);
    d) employment situation (the fact that the client might lose his/her job or is close to retirement may impact his/her financial situation or its financial investment objectives);
    e) the need for liquidity in certain relevant investments;
    f) Personal preferences related to the environmental and/or social impacts of investments, including for instance the willingness to invest explicitly in areas supporting the transition to a low-carbon, resource-efficient economy.
27. The assessment of preferences regarding environmental or social impacts should include questions about the willingness to invest in entities that run strategies inconsistent with the client's non-financial objectives, the use of shareholder rights to support and/or influence the management of these entities, and the trade-off that the investor is willing to make to prioritize social or environmental outcomes. The assessment will at least confirm the intention of the client vis-à-vis the support of the implementation of the Paris agreement. New ESMA Q&A on investor protection will be issued to provide further guidance and include definitions of relevant concepts."

Source: **Non-financial message in a bottle** - How the environmental objectives of retail investors are overlooked in mifid ii – priips implementation (2Dii, 2017)

ANNEX 4 – EXAMPLE OF SUSTAINABILITY LABELS APPLIED TO ALL FUNDS

- **Climetrics** (CDP) Using the most advanced metrics available, Climetrics has developed an independent, rules-based and transparent methodology to communicate the overall climate impact of investment funds. The methodology was developed by the ratings data providers CDP and ISS-Ethix Climate Solutions in consultation with NGOs, asset owners and managers as well as members of the academic community. Also including a number of external data sources, it scores funds across three levels to produce its 1-5 green leaf rating. Climetrics covers roughly 55 percent of the assets invested in equity funds that are currently for sale in Europe, representing about €2 trillion in fund investments.
- The Sustainability Rating™ (Morningstar) is a measure of how well the holdings in a portfolio are managing their ESG risks and opportunities. The rating is a holdings-based calculation using company-level ESG analytics from Sustainalytics. It is calculated for managed products and global indices using Morningstar's portfolio holdings database.