

ADVICE TO ESMA

Response to ESMA's Consultation Paper on "Guidelines on certain aspects of the MiFID II suitability requirements"

I. Executive summary

1. On the whole, the SMSG is of the opinion that the draft guidelines are sound and beneficial to the protection of the investor. The SMSG is particularly happy with the approach taken by ESMA to not merely update the previous guidelines in light of the MiFID II, but to also thoroughly re-examine all guidelines and add new guidance where necessary (in particular in respect of robo-advice). Also references to insights of behavioural economics and the insertion of a correlation table are much appreciated. Furthermore the explicit confirmation of the "portfolio approach" to investment advice and portfolio management (para 80-81), consistent with the guidelines on target market, is applauded by the SMSG. However, the SMSG also has a number of general comments.

2. First, implementation of the guidelines will not be straightforward and will require time and costs (see in more detail the answer to Q13).

3. Second, the SMSG is of the opinion that some of the specific guidelines in respect of robo-advice are important for *all* investment advice and portfolio management services which use questionnaires (e.g. para 21, first bullet; para 30, last bullet). On the other hand, robo-advice is just one of different possible channels to provide investment advice or portfolio management. Investment firms providing robo-advice should therefore fully comply with the MiFID II suitability standards. The SMSG further advises ESMA to provide specific further substantive requirements in respect of robo-advice and the use of questionnaires in general, going beyond mere information requirements to the client (see para 13 of this advice).

4. Third, a number of guidelines require investment firms to provide additional information to clients, on top of the already rather heavy information requirements in the level 1 and 2 texts (see e.g. para 16, 17, 21). In view of the dangers of information overload, the SMSG is not in all instances convinced of the added value of adding this information as a tool of investor protection (e.g. para 17, last bullet of para 21, see also response to Q1).

Similarly, the SMSG favours the use well-balanced sets of questions to acquire the necessary client information. The SMSG acknowledges that nuanced investor profiles should be based on client information with respect to a wide array of elements, which will usually require answers to a large set of detailed questions. It is however important that investors do not perceive (part of) those questions as irrelevant, as this risks to revolt clients against the suitability process. The SMSG therefore welcomes guidelines 1 and 3 and implementing guidelines. It is indeed important that

the purpose of the suitability process is well explained and that only well-formulated questions, which are relevant to the client's situation, are asked (see also para 14 of this advice).

5. Fourth, the SMSG is of the opinion that communication with the younger generation should also be a point of attention. This may mean that other ways of communication than via questionnaires or face-to-face discussions may be relevant for purposes of the suitability assessment (see e.g. para 86, last bullet) and may be another point of attention for ESMA to follow up.

6. Finally, the SMSG thinks it is important that ESMA consults with EIOPA on these draft guidelines. The IDD provides for suitability requirements for insurance-based investment products, which are more or less copied from the MiFID II, in order to create a level playing field between economically very similar products. In order to ensure that such level playing field is maintained at the level 3, ESMA and EIOPA should cooperate to draft common guidelines on suitability under MiFID II and IDD. Recital 87 of MiFID II indeed encourages EIOPA and ESMA to work together to achieve as much consistency as possible between the conduct of business standards for insurance-based investment products and the MiFID II investment products.¹ This will also allow firms offering both MiFID II and insurance-based investment products, to streamline their processes for both types of products.

II. Background

7. On 13 July 2017, ESMA published a consultation paper on "Guidelines on certain aspects of the MiFID II suitability requirements", pursuant to the suitability requirements laid down in Articles 25(2) of MiFID II, as well as in Articles 54-55 of MiFID II Delegated Regulation (EU)2017/565. Within the SMSG a working group has been established to comment on these guidelines. This advice reflects the discussions of the working group as well as the issues raised in the plenary session of 21 September 2017.

¹ This is in line with a consistent EU policy since 2009. See European Commission, "Communication to the European Parliament and the Council: Packaged Retail Investment Products" COM(2009)204 final at 8-9: "*practical experience with both MIFID and the IMD remains limited. nevertheless, the European Commission is concerned that inconsistencies in the standards of sales practice for retail packaged investment products in these two directives increase the potential for investor detriment and regulatory arbitrage. ... The European Commission believes that the existing sectoral patchwork must be replaced by a horizontal approach to both mandatory disclosures and selling practices. This approach will promote consistent outcomes regardless of the legal form of the product or the distribution channel employed, and could be extended to continued innovation in the retail market*" and European Commission, "Staff Working Document on the follow up in retail financial services to the consumer markets scoreboard" SEC(2009)1251 final at 13: "*With regard to sales of PRIPs, the Commission is committed to ensuring consistent and effective regulation for all sales of PRIPs, taking MiFID as a benchmark, so as to remove current variations in the standards applying to sales depending on the legal form of the product...*".

III. Comments on the different questions in the consultation

Q1: Do you agree with the suggested approach on the information to be provided on the suitability assessment and specifically with the new supporting guidelines on robo-advice? Please also state the reasons for your answer.

8. The SMSG in general welcomes the suggested approach. It nevertheless has a number of comments.

9. P. 37, para 6: Definition of “investment product”: The SMSG welcomes the introduction of a definition of “investment product”, a term which is used in MIFID II, but not defined. However, in line with the general comment that the guidelines should be common guidelines of ESMA and EIOPA under MiFID II and IDD (see executive summary), the SMSG thinks that ESMA should consult with EIOPA in order to come up with one common definition, which should ideally be broader, and also cover insurance-based investment products. Recital 87 of MiFID II indeed uses the term “investment product” to refer to insurance-based investment products.

10. P. 38, para 6: Definition of “robo-advice”: The SMSG welcomes the introduction of a clear definition of robo-advice in the guidelines. The SMSG however has a number of concerns relating to the proposed definitions:

- Almost any investment firm, including most non-FinTech firms, use some kind of automated system to process client data and match suitable investment products. By including in the definition of robo-advice services that are delivered “only in part” through an automated or semi-automated system, the proposed definition is too wide.
- The SMSG believes that the definition should be aligned to the concept of “automation in financial advice” in the Joint ESAs’ Report on automation in financial advice (see p.7, para 3).

The SMSG’s proposal of a definition is therefore: *“the provision of investment advice and/or portfolio management services rendered by computer-based algorithms and/or decision trees without client-facing human intervention or without human intervention at all”*.

11. P. 40, para 17: The SMSG believes it unnecessary to inform clients “that they may be asked to answer some questions related to situations describing, for example, different levels of loss/return...”. Either such questions will be asked – and then the firm should explain at that moment why these questions are asked and how the answers are useful in assessing the clients knowledge and experience – or such questions are never asked – and then it is unnecessary and even confusing to bother clients with this information.

12. P. 40, para 19: The SMSG agrees that disclaimers should not be used by firms to evade their responsibilities. On the other hand, a bold prohibition for investment firms not to use any disclaimers, seems too harsh. It should still be possible for firms to warn clients that the firm will be unable to provide a correct suitability assessment if the client willfully provides wrong information or willfully withholds information. Such warning could be read as a disclaimer that the firm is not responsible for a wrong suitability assessment if the client willfully provides wrong information or willfully withholds information (see also para 43).

13. P. 40-41, para 21:

- The SMSG is of the opinion that next to mere information obligations to clients, also more substantive guidance is necessary in respect of robo-advice, and the use of questionnaires in general. First, it is important that a *sufficient number of questions*, respecting the principle of proportionality, is asked of clients, so as to allow the determination of a sufficiently nuanced investor profile (see also para 78 of the draft guidelines, which requires that investor profiles should not be too broad). Second, it has been shown that, even when many questions are asked to clients, the number of answers *actually used to determine the profile* is often small. In line with the requirement that the client profiles should not be too broad, all client answers should be used in the determination of a sufficiently nuanced client profile, although the weight given to answers can vary from question to question. The service provider must be able to justify the choices made in modeling the algorithm used.
- the first bullet seems to be equally important for non-robo-advice firms which make use of some kind of automated system to process client data and match suitable investment products. The third and fourth bullet seem to be important for all firms providing investment advice or portfolio management. The SMSG therefore suggests to give those bullets a wider scope of application.
- third bullet: This bullet is ambiguous. “*A description of how the firm will use the information gathered*” can be read as a requirement to disclose how the models and algorithms process the client information to generate advice or investment decisions. The example which is given seems to indicate that ESMA rather wants the firm to warn the client, as the case may be, that investment advice and investment decisions are solely based on the information provided by the client. To avoid any discussion, the SMSG suggests to change the wording of this paragraph as follows: “*A description of the sources of information used to generate an investment advice...*”.
- fourth bullet: It seems useful to add: “and how the client can spontaneously request an update of his or her status in case his or her situation has changed or will change in the near future”.

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? Please also state the reasons for your answer.

14. The SMSG in general welcomes the suggested approach. It nevertheless has a number of comments.

15. P. 41, para 25:

- the use of the word “biases” seems to be ill-chosen in this context. The word “bias” is typically used in behavioural finance literature, to describe systematically irrational

human behaviour (confirmation bias, hindsight bias, herd behaviour, ...). The guidelines refer to techniques to increase the attractiveness and readability of questionnaires, which are indeed very valuable. The elements mentioned in the bullets are rather instances of how to maximize chances that investors will actually read, understand and respond to all questions. The word “biases” could be replaced by “reasons why investors fail to answer or fail to answer questionnaires correctly”.

- The second bullet of para 25 refers to the importance of the layout of questionnaires, which should avoid orienting investors choices. The SMSG is of the opinion that a more general warning on the importance of layout, also of a website (especially for robo-advice) would be appropriate, since the layout of the website can already steer investors towards certain products or services, thus impairing the suitability process.
- The third bullet of para 25 actually refers to two different issues (presenting questions in batteries, and order of the questions in the questionnaire). It would therefore be better to split this bullet into two separate bullets.
- Fourth bullet of para 25: *“questionnaires allowing the reply “no answer” too often should be avoided”*. This is a very vague guideline. It is unclear what would be “too often”. It should always be the investment firm who decides whether a certain question is relevant and necessary to be answered or not, in function of the particular circumstances of the client. It may be that a question is not applicable for a certain investor, and the option “not applicable” should then be made available. In certain circumstances it may indeed be left to the investor to decide whether a question is not applicable to his or her situation. The decision whether a question can be left unanswered on the other hand, depends on the circumstances of the client (type of advice, type of instruments on which advice is sought, ... see also para 32 of the draft guidelines). The client should in our opinion not be expected to make this assessment himself. This would be contrary to draft guideline 1 as well as to paras 28 and 44 of the draft guidelines.

The SMSG therefore advises that the reply “no answer” should in principle not be available in questionnaires, but that investment firms can use the reply “not applicable” in limited circumstances.

In order to tailor questionnaires to the needs of their clients investment firms can (i) use different questionnaires for different situations, so that in more complex situations, more elaborate questionnaires would be used, or (ii) elaborate questionnaires in such a way that when a certain question is answered in the negative a number of questions can be skipped, or (iii) allow a client not to answer a certain question if *the firm* decides that in the situation of that particular client, the answer to that question is indeed not necessary to make a correct suitability assessment. The firm should in the latter situation document why the answer to that question is not necessary for that client.

In this way it is always the investment firm who decides whether a certain question is relevant and necessary to be answered or not, in function of the particular circumstances of the client.

16. Para 26:

- More guidance on the exact meaning and scope of a number of concepts would be useful. Questions about “risk tolerance” should, for instance, not be mixed up with other questions about investment objectives or time horizon. Although they are closely linked elements, each should be questioned separately in order to get a correct image of the actual investment objectives of the client.
- Similarly the concept of “risk tolerance” should be clearly separated from the concept of “risk capacity” or “capacity for loss”. The first tests the client’s willingness to take on investment risk (= investment objective); the second tests whether the client can financially bear risks involved with aiming at those objectives (= financial situation).
- The SMSG deems it important that ESMA should hold a consultation allowing to provide concrete guidance on the suitability process. ESMA should consider to give an overview of “good practices” and “bad practices” regarding the suitability assessment.

17. Para 28: This paragraph uses the term “self-assessment” for the first time. It would be useful to add a cross-reference to para 44, were different examples of self-assessment are given.

18. Para 29: the use of the concept “financial literacy” should be deleted. It is a potentially very broad term, which has not been defined. The paragraph is sufficiently clear by referring to the need to appraise the client’s understanding of basic notions, with the examples given.

19. Para 30: the SMSG agrees with the further clarifications for robo-advice. However, the first, second and certainly the last bullet also seem relevant for all suitability assessments which make use of questionnaires. The guidelines could state that non-robo-advice firms need to reach the same result, either by using similar techniques, or by ensuring that well-trained staff support clients when they fill out the questionnaire.

Q3: Do you believe that further guidance is needed to clarify how firms should assess clients’ ability to bear losses?

No comments.

Q4: Do you agree with how the guideline on the topic of ‘reliability of client information’ has been updated to take into account behavioural finance and the development of robo-advice models? Please also state the reasons for your answer.

20. P. 45, para 32:

- In determining what information is “necessary” and relevant, firms should also consider the range of products which the firm takes into account for its investment advice or portfolio management. If only a few types of products are offered, questions on other types of products are obviously obsolete.

- This guideline seems to have a circular character in respect of c): the firm will only be able to assess the nature, needs and circumstances of the client after it has obtained the necessary and relevant information. Information on the nature, needs and circumstances of the client will, however, often not be available to the firm before the suitability has been assessed.

21. P. 45, para 34: This paragraph states that more in-depth information may need to be collected “when providing access to complex or risky products”. The majority opinion of the SMSG feels it is important that a “client-first” principle should always prevail: the firm should assess the client’s situation first, before deciding what products can be made available to the client. A “product-first” approach, where a firm wants to sell a product and checks for what clients the product may be suitable, should be avoided, and should only be allowed if the client takes the initiative and asks to buy a certain product. A minority of the SMSG disagrees, however, with this opinion. According to the dissenting opinion it is current practice that a certain product is selected and promoted to clients for whom it is suitable. The dissenting opinion states that this should not be a problem, as long as the product is only promoted to carefully selected clients for whom the product is indeed suitable.

22. P. 47, para 37: The SMSG in principle agrees with the approach taken in this paragraph. The SMSG however believes that the example should be replaced with a better example, since the question whether the client asks advice over his or her full portfolio or only over a part of his or her portfolio, should not necessarily impact the level of detail of information collected about a client. In order to give suitable advice on a part of the portfolio, the firm needs as much information on the client’s objectives and knowledge and experience as when the full portfolio is advised upon. A full assessment of the client’s financial situation is equally important, in order to assess whether the client can financially bear the consequences of a certain investment strategy. The SMSG is of the opinion that the example should be replaced by a request for “focused advice” on a particular product for a particular purpose (e.g. to save for children’s’ school fees), which may indeed allow to collect more limited information on that client. Such “focused advice” on a particular product for a particular purpose should only be given on the client’s initiative and request. The SMSG advises that ESMA clearly defines the concept of “focused advice” for these purposes.

Q5: Do you agree with the suggested approach on the topic of ‘updating client information’? Please also state the reasons for your answer.

23. P. 51, para 54: ESMA suggests to implement verification procedures based on profile changes. We entirely endorse the objective of avoiding abusive behavior, and support enhanced vigilance with respect to the possibility of unjustified or opportunistic profile changes. Nevertheless we note that profile changes by their nature generally occur at the time of client interviews, which frequently coincide with investment decisions. Accordingly the SMSG considers that there should not be a presumption of bad faith in case of a profile change concomitantly with a transaction.

Q6: Do you agree with the suggested approach to conduct the suitability assessment for a group of clients, especially where no legal representative is foreseen under applicable national laws? Please also state the reasons for your answer.

No comments.

Q7: 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.

24. P. 56, para 70-71: The word “the firm” in para. 70 does not distinguish between the respective roles of manufacturers and distributors and hence also exposes the distributor to the obligation to assess product risk. While MiFID II (art 24, 2) clearly includes the obligation to understand the products that a firm is offering, neither MiFID II itself, nor the Delegated Directive, nor the ESMA Final Report on MiFID II product governance guidelines include the obligation for the distributor to assess himself the product risks. Rather there is an obligation to get informed so as to understand the risks and be able to assess their relevance for their clients. In many situations, the distributor will be able to rely on information already available such as the target market description by the manufacturer or, for PRIIPs, the risk description in the PRIIPs KID.

Q8: Do you agree with the additional guidance provided with regard to the arrangements necessary to ensure the suitability of an investment? Please also state the reasons for your answer.

25. P. 58, para 78: *“tools that classify clients or investment products broadly would not be fit for purpose”*. This is very vague. Today many firms work with 4 to 6 investment profiles, resulting in rather broad categories. It is not clear whether this would be considered “too broad”. On the one hand the SMSG is wary that ESMA or national authorities would be too prescriptive in this regard, as there is not one optimal approach. It is necessary that market participants can keep on experimenting in order to optimize their approach. On the other hand some further guidance on what number of categories may be sufficiently refined, would be helpful.

Moreover, the SMSG is concerned in this respect that the wording used to refer to client categories should not have a positive or negative connotation. The terms “dynamic” or “conservative”, for instance, may lead investors to prefer one category over another, while this does not correspond to their actual investor profile (e.g. young people may prefer a “dynamic” investor profile over a “conservative” profile). The use of more neutral and direct terminology (risk-averse vs risk-taker) can avoid this.

26. P. 60, para 83: Whereas the requirement that a client’s portfolio be monitored in terms of credit risk exposure indeed seems a reasonable requirement in order to ensure sufficient risk spreading, it may have far-reaching consequences for investment firms mainly offering products from the same counterparty.

Q9: Do you agree with the suggested approach for ensuring that firms assess, while taking into account costs and complexity, whether equivalent products can meet their clients' profile? Please also state the reasons for your answers.

27. P. 61, para 87: The SMSG has two comments regarding this paragraph:

- The draft guidelines include the obligation to assess "equivalent" products. However, they only describe in a very general way what is meant by 'equivalent' ("in terms of the ability to meet the clients' needs and circumstances such as financial instruments with similar target markets and similar risk-return profile"). The SMSG is of the opinion that ESMA will need to provide further guidance on how broad or how narrow the notion "equivalent" should be interpreted. The SMSG advises that ESMA closely monitors the development of market practices on this topic and engages in a public consultation, in order to come up with further guidance and promote the necessary convergence in this area.
- The requirement to compare and assess equivalent products on cost/complexity has, especially for integrated financial institutions, far-reaching implications as compared to the present way of working, where advice is usually based on single products or a limited range of products, that are brought in the picture by HQ through supporting material to sales and staff personnel. This requirement has the clear advantage that it further reduces the scope for product-pushed advice, already initiated by the ban on product-based sales targets. However, this goes against "corporate culture" in many firms and may therefore create a tension for sales and advice staff between the new regulatory requirements on the one hand and an existing 'corporate culture' on the other. It should be clear that it is the responsibility of management to ensure that the necessary procedures and processes are put in place to facilitate compliance with the new requirement. For this reason, the SMSG suggests to add the following sentence to para 87: *"These procedures should include a clear delineation of responsibilities to respect the conflicts of interests rules and the rules on inducements, and to avoid undue incitements towards sales and advice staff to consider only a narrowed range in the assessment"*.

Q10: Do you agree with the suggested approach for conducting a cost-benefit analysis of switching investments in the context of portfolio management or investment advice? Please also state the reasons for your answer.

28. P. 63, para 93:

- See comment on Q9, para 87
- The SMSG is of the opinion that the "potential net return" is indeed an important factor to take into account. The SMSG, however, expresses the concern that a switch on the basis of a better potential net return, should not be based on estimates. The calculation of the "potential net return" should, on the contrary be based on solid and objective calculations, strictly following the provisions of MiFID II Delegated Regulation (MiFID II Delegated Regulation, Chapter II, Section 1, Article 44, 6(e)) on such projections.

- The SMSG is of the opinion that when comparing the potential net return of the proposed alternative and of the existing asset, also the risk of both assets should also be considered: it is the risk/return profile of both assets which should be compared.
- In accordance with the interim report of the High-Level Expert Group on Sustainable Finance,² the sustainability of the product should be mentioned by ESMA as an element which investment firms can take into account as a non-monetary factor, especially when the client expresses this as a need.

Q11: Do you believe that further guidance would be needed with regard to the skills, knowledge and expertise that should be possessed by staff not directly facing clients, but still involved in other aspects of the suitability assessment? Please also state the reasons for your answer.

29. P.65, para 100: The SMSG is of the opinion that it is important to stress the need for appropriate training in respect of skills, knowledge and expertise of staff. The SMSG therefore suggests to add the following sentence to paragraph 100: *“In line with the “ESMA Final Report: Guidelines for the assessment of knowledge and competence”, V.IV.20b, the firm should provide training, where appropriate, on the new elements regarding suitability assessment, introduced by these guidelines.”*

Q12: Do you have any further comment or input on the draft guidelines?

30. See general remarks in the executive summary.

31. It would further be useful if ESMA would explicitly provide that the new guidance will only apply to investment advice or portfolio management provided after the date of entry into force of the guidelines. The date of entry into force should take into account the time needed to implement the guidelines (see answer to next question).

32. Further, the SMSG deems it useful for ESMA to remind firms to the need to comply with the GDPR in respect of client data gathered in the context of the suitability process. More in particular it should be stressed that: (i) personal data can only be collected for specified, explicit and legitimate purposes and should not be further processed in a way incompatible with those purposes (art. 5 (1) b) GDPR); and (ii) such data should be adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed (art. 5 (1) c) GDPR).

33. Closely related to the previous point are the risks of cybersecurity, especially in respect of robo-advice. The SMSG therefore advises ESMA to urge investment firms in general, and robo-advice firms in particular, to take the necessary measures and devote sufficient funds to cybersecurity in the context of the suitability assessment.

² “[ESG factors and sustainability risks and opportunities] will also need to be reflected in the role played by the European supervisory agencies (ESAs), such as through common guidelines”. See High-Level Expert Group on Sustainable Finance, “Interim report to advice on developing a comprehensive EU strategy on sustainable finance” (July 2017).

Q13: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

34. Implementation of the guidelines is not straightforward and will require time and costs, especially in view of the following issues:

- Renewed suitability assessment. Firms will first have to reflect on how suitability can be assessed in a way consistent with these guidelines. To the extent that new questionnaires have to be developed, and new suitability assessments made, this will require (i) contacting existing clients to do the new suitability assessments, which will take time, especially in case the firm has a broad client base; (ii) training of staff and (iii) possibly adjusting ICT systems to archive answers on new/amended questions.
- Development of ICT tools. In particular we would like to point at the following elements:
 - o To reduce the risk of errors in the advice and to allow ex post reporting and monitoring for compliance reasons, the client's answers to questionnaires (or related tools) need to be stored into databases from which they can be retrieved. Existing databases will probably have to be changed to incorporate the new requirements;
 - o Analysis of credit concentration in a client's portfolio. While this is a sound requirement, an automated verification of credit concentration would be useful (although not necessary) to assist the process of advice. However, it would be essential for ex-post monitoring. This would require that tools are set up to determine credit concentration in an automated way.
 - o Comparison of the product with equivalent products. Both to facilitate the comparison and the ex-post monitoring, this would preferably be supported by automated tools. This would require ICT applications to select the equivalent products, indicate the relevant criteria (such as cost, complexity,.....) and at the very least record the cases when a more costly/complex one... was advised and the motive.

35. By pointing at these elements, the SMSG does not doubt the soundness of the proposals, nor the benefits which sound suitability standards will produce for investment firms and clients, in terms of better advice and portfolio managements, increased investor trust and increased client satisfaction. The SMSG is indeed convinced of the necessity to spend sufficient efforts and funds to achieve consistent and genuine compliance with the suitability requirements. The SMSG nevertheless wants to indicate that a significant transition time will be needed before these guidelines will be fully implemented.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 8 November 2017

[Signed]

Rüdiger Veil

Chair

Securities and Markets Stakeholder Group