Securities and Markets Stakeholder Group

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ESMA/2012/SMSG/11

ADVICE TO ESMA

Guidelines on certain aspects of the MiFID suitability requirements

I. Executive summary

The Stakeholder Group supports the adoption of Guidelines related to MiFID and the overall approach of ESMA with respect to the Guidelines. However, it also makes a number of suggestions for revisions to enhance the Guidelines.

The Stakeholder Group supports the adoption of Guidelines on certain aspects of the MiFID suitability requirements and shares the overall approach of ESMA in the Guidelines. This issue is of high importance and recent experience shows that regulators regularly identify deficiencies in this area. Therefore the adoption of Guidelines should contribute effectively to enhancing consumer protection, which is one of the ESMA's objectives. The proposed Guidelines should also contribute to establishing a sound, effective and consistent level of regulation and supervision. However, the Stakeholder Group notes that a real and effective "consistent level" of investor protection regulation and supervision will only be achieved if the MiFID suitability provisions and ESMA Guidelines are extended to all other retail investment products. Currently, MiFID covers only a minority percentage of all investment products being offered and sold to individual investors in the European Union. Therefore, the Securities and Markets Stakeholder Group (SMSG) hopes that this consistency issue will be addressed by the upcoming initiative on Packaged Retail Investment Products (PRIPs) and Insurance Mediation Directive review proposals from the European Commission.

While strongly supporting both the timing and the content of the Guidelines, the Group would like to call the attention of ESMA to a number of specific elements which, in the opinion of the Group, could strengthen investor protection.

In general, Questionnaires should not be excessively relied nor used by investment firms to reverse the burden of proof. Live discussion and interaction between firm and client is the best method for understanding client needs.

With respect to the information which must be collected by the investment firm, there is a need to take a broader view and not to over-rely on a distinction between « risky and illiquid investments » and other investments.

The Group supports the requirement that investment firms should ensure that staff involved in material aspects of the suitability process have the skills and the expertise to discharge their responsibilities. In this regard, there is a very strong support within the Stakeholder Group that professional qualifications, such as the ones recently launched in the United Kingdom, in France and established since 2001 in Sweden should be strongly encouraged.

The distinction proposed between investment advisory services and portfolio management regarding the information to be collected by investment firms should not be given too much importance. On the contrary, there is an even greater need for protection of clients in case of discretionary advice. In the case of portfolio management services, this protection implies not just that the client “understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio” but that the investment firm also gain a very “clear understanding” and an “in-depth knowledge” of the profile of the client, of its psychology and of its investment strategy.

With respect to the “suitability” assessment, the Group believes that the Guidance places too much emphasis on “relevant risks”. The concept of risk is very abstract and is, too often, subject to underestimation by investors and investment firms alike. The capacity of an investor to bear a permanent loss should instead be used (or at least to a similar extent) by investment firms. The loss-sustaining capacity of the investor should be considered carefully, and in a practical manner.

The age of the investor should be given more importance in view of recent major cases of mis-selling to elderly retail investors.

The guidelines need to emphasise that investment firms consider whether non-tradable products, and particularly basic deposit products, can satisfy the suitability requirement, depending on the circumstances.

Conflict of interest risk is particularly acute when investments are recommended or a portfolio is managed. Therefore, the Group suggests that the uidelines provide a more explicit explanation as to how conflicts of interest should be prevented. The guidelines currently makes simply a general comment on this point.

II. Explanatory remarks

1. On December 22, 2011 ESMA published a consultation paper relating to proposed Guidelines regarding the implementation of certain requirements of the Markets in Financial Instruments Directive (MiFID). The purpose of the Guidelines is to enhance clarity and foster convergence in the implementation of certain aspects of the MiFID requirements.

2. The first Guideline deals with the core issue of the MiFID "suitability" requirements (ESMA/2011/445). Article 19(4) of MiFID states that when providing investment advice or portfolio management services, investment firms must ensure that the specific transaction to be recommended, or entered into in the course of providing a portfolio management service, is suitable for the client (or potential client) in question. The second Guidance (ESMA/2011/446), on MiFID’s compliance requirements, is addressed in a second SMSG Report. The suitability Guidelines are divided between General Guidelines and Supporting Guidelines. They deal only with certain aspects of MiFID.

3. The adoption of Guidelines by ESMA is subject to article 16 of the ESMA Regulation which provides that ESMA "shall, with a view to establishing consistent, efficient and effective supervisory practices within the European System of Financial Supervisors (ESFS), and to ensuring the common, uniform and consistent application of Union law, issue Guidelines and recommendations addressed to competent authorities or financial market participants". Both Guidelines are addressed to competent authorities which are subject to the "comply or explain" approach imposed by article 16(3) of the

Regulation. The Guidelines are also addressed to financial market participants. However, participants are not under a duty to report, "in a clear and detailed way, whether they comply with that Guideline... ".

4. The two Guidelines constitute new developments at the EU level. They do not duplicate previous work by the Committee of European Securities Regulators (CESR). However, they build on existing requirements developed by national regulators. The Guidelines on suitability requirements originate from evidence and concerns that "full and effective compliance with the MiFID suitability requirements is not as consistent or as wide-spread across EEA member states as it could or should be".

5. The Group supports the proposed Guidelines on suitability, but has some comments and would like to suggest some improvements on specific points.

III. General comments of the Group on Guidelines on certain aspects of the MiFID suitability requirements

III.I. Information to clients about the suitability assessment

6. The Group supports the requirement that the information provided by investment firms about the services they offer should include information about why and how suitability is assessed.

III.II. Arrangements necessary to understand clients and investments (Question 2)

7. Article 19(4) of MiFID and Article 35(1) of the MiFID Implementing Directive require investment firms to understand the essential facts about the client and the characteristics of any investments that may be recommended to the client or made on his behalf in providing a portfolio management service. The Group has several concerns on this issue.

Paragraph 21 (No excessive reliance on questionnaires)

8. The Group is concerned that too much emphasis is being put on the use of questionnaire to the detriment of a physical meeting with a representative of the investment firm. A questionnaire is an essential tool in order to identify the investor's profile. However, a questionnaire is also a very imperfect tool and is just a tool. Questionnaires have weaknesses. They are often long and complex, and are written in a technical language which might not be easily understandable by most retail investors. Faced with complex questions on unfamiliar topics, retail investors are vulnerable to errors. Questionnaires can also have in-built flaws. Such flaws can result in inappropriate answers and interpretation of responses. Therefore, it is preferable to complete the questionnaire at a physical meeting with the investment firm, or at least a live discussion (e.g. phone) with the investment firm. This step would prevent misunderstanding of terms, either technical or plain-English terms which are subject to different interpretations by the investment firm and by the retail investor.

9. As a consequence, the Group is also especially concerned with internet-only questionnaires. Online questionnaires should not be encouraged and investment firms using these methods should be subject to increased supervision by competent authorities. In this situation also, live discussion between the client and the investment firm should be encouraged as much as possible.

10. In addition, when questionnaires are used, they should, when and as they deem appropriate and also to the extent possible in terms of costs, be tailor-made. However, some members of the Group consider that it is not possible to individually tailor make questionnaires

11. The Group also supports the use of all available information to assess the profile of the client, such as information from previous contractual relationships with the firm, or information which is publicly available. In addition, it should be clear that the responsibility for the suitability assessment should always remain with the investment firm, and should not be passed onto investors via these documents and systems.

12. The Group advises that the Guidelines include an explicit reference to the need for the investment firm to always exercise judgement and to take into account the human factor when dealing with clients or prospective clients.

Paragraph 23 (Possible products)

13. Paragraph 23 mentions that "Investment firms should also know the products they are offering." As to the type of investment which would be suitable, the Group considers that non tradable products and particularly basic cash deposits, may be the best advice in certain circumstances, given the risk profile and risk appetite of the investor or given the general economic outlook. Investment firms should look beyond proprietary products and tradable products generally. Cash deposits should be mentioned as suitable "investments" especially for customers which are unwilling or unable to accept the risk of loss of capital. Investors with large cash deposits should, as some bank defaults have been experienced in Europe, be informed of the level of deposit insurance in their jurisdiction.

Nature of the recommendation

14. Another issue which is of great concern to the Group is that the suitability test is too much focused on one financial instrument that could be recommended to the client. In many cases, especially when first providing investment advice, investment firms tend to advise clients to reconstruct or to shift their portfolios. These portfolio reconstructions do not always lead to a new or different structure of the portfolio. However, the restructuration of the client portfolio leads to a portfolio turnover and potentially to high costs. The same risk lies with portfolio management services. Portfolio restructuration might constitute a perfectly suitable advice as such and should certainly not be discouraged since it is part of the duties to analyse an existing client portfolio. However, investment firms should at the same time be mindful of the cost of the restructuration.

15. As a consequence, the Group suggests extending the suitability test. Every recommendation must be suitable, whether it is a recommendation to buy, to hold or to sell.

Role of regulators

16. Competent authorities themselves can have a role in enhancing investor protection by providing market education. Local supervisors should be encouraged to assume a more active role in communicating to potential investors information about investing generally and what to look for when selecting financial instruments or when seeking investment advice/portfolio management services. However, investor education is no substitute to investor protection which remains the paramount goal of securities regulators.

III.III. Qualifications of investment firm staff

17. The Group supports the requirement that investment firms should ensure that staff involved in material aspects of the suitability process have the skills and the expertise to discharge their responsibilities. This is particularly the case given the complexity of certain products frequently sold to retail investors. This requirement cannot be underestimated by investment firms and might even be the most important in terms of investor protection.

18. However, such requirement should be applied in a sensible and cost effective way. Therefore, investment firms should not be subject to rules forcing them to hire experts which meet certain requirements. Employees engaged in this type of activity should be trained and qualified, but it should be clear that such training and qualification can also be acquired in the course of discharging their obligations, as well as through practical work and by means of training provided by the investment firm in a cost efficient way. Requirements of a formal nature, such as type of education, previous experience or training courses attended are an advantage, and professional qualifications, such as the ones launched recently in the United Kingdom, in France, and established since 2001 in Sweden should be strongly encouraged.

19. Members of the Stakeholder Group coming from Member States which have introduced such professional qualifications indicate that their view, as well as the one of their country financial industry, with the benefit of experience, is quite positive. For instance, Sweden has had since 2001 a compulsory certification of investment firm staff ("Swedesec Licence"). In France, a compulsory certification of investment firm staff, and especially of sales persons, was established and entered into force in July 2010.[1] In France large banks had long been reluctant to such requirement but now they consider it as a real advantage. In the United Kingdom, a new national qualifications regime for advisers will come into force in 2013 as part of the Retail Distribution Review (RDR) launched in June 2006.[2] Despite concerns that large numbers of advisers would leave the industry, recent FSA reports show that the industry is moving over to the new qualifications regime and that while advisers are leaving, the numbers are not as great as expected, and, indeed, that parts of the industry support the higher standards.[3] A similar requirement exists in the US.

20. As another example, in Germany as of 31 October 2012 investment firms will have to instate investment advisors only if they are competent and reliable. These characteristics will have to be proved by the investment firms and have to be verified to the authority on their demand.

III.IV. Extent of information to be collected from clients (proportionality) (Question 4)

21. Before providing investment advice or portfolio management services, investment firms always need to collect "necessary information" about the client's knowledge and experience, financial situation and investment objectives (Paragraph 26). In general, the Group has some concerns with respect to the "proportionality" approach adopted by the Consultation paper.

Paragraph 27 (Proportionality at the start of the financial relationship)

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[1] Art. 313-7-1 of the General Regulation of the Financial Markets Authority (*RGAMF*).
[2] On the RDR, See. http://www.fsa.gov.uk/about/what/rdr.
[3] Research: Progress towards the Professionalism requirements of the Retail Distribution Review, by Bryan Atkin, Naomi Crowther, Dominika Wintersgill and Andrew Wood, A research study for the FSA, 6 December 2011.

22. Paragraph 27 mentions that “The extent of information collected may vary”. This is so because investment firms should consider “(a) the type (including the complexity and level of risk) of the financial instrument or transaction to be recommended or entered into; (b) the nature and extent of the service; (c) the nature, needs and circumstances of the client.” The Group is of the view that the necessary information should not vary depending on the type of the recommended financial instrument. This is so because recommendations cannot be given at the beginning of the advice process, but are given at the end of it. Therefore, the information collected from clients at the start of the process should be as complete as possible, and not be dependent on the potential instruments which may be the subject of subsequent advice.

Paragraph 29 (Proportionality as to the nature of the financial instrument)

23. The Group is very concerned that the ESMA Guidelines seem to identify "risky or illiquid financial instruments" only as requiring the collection of particular and detailed client information (Paragraph 29). There is a strong support from the Group that this distinction not be made, and that the relevant information noted in Paragraph 29 is collected in all suitability assessments. The financial crisis has shown that this distinction, although valid, might not always be easy to apply in real life situations. Therefore, the type of information mentioned in Paragraph 29 should also be collected (the exact extent on the circumstances, in cases relating to “non-risky and liquid investments”.

24. In addition, with respect to the extent of the “necessary information” to be collected on the “financial situation” of the client, the Group considers that the client’s debt burden must clearly be part of the information requested from the client. The Guidelines currently only refer to “financial commitments” (Paragraph 29(c)). Information on debt should be requested. It should include debits, the total amount of indebtedness and the monthly charge.

Paragraph 30 (Proportionality as to the nature of the service to be provided)

25. Before providing investment advice or portfolio management services, investment firms need to collect « necessary information about the client’s knowledge and experience, financial situation and investment objectives.[4] Paragraph 30 of the Guidelines, referring to article 35 of the MiFID Implementing directive[5], states that “In determining the information to be collected, investment firms should also take into account the nature of the service to be provided”. As a consequence, the Guidelines distinguish between investment advisory services and portfolio management services (discretionary advice). Where portfolio management services are to be provided, the Guidelines mention that "it is reasonable to consider that the client’s level of knowledge and experience with regard to all the financial instruments that can potentially make up the portfolio may be less detailed than the level that the client should have when an investment advisory service is to be provided. Nevertheless, even in such situations, the client should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio" (Paragraph 30(b)).

26. The Group believes that the distinction proposed between investment advisory services and portfolio management regarding the information to be collected by investment firms, should not be given too much importance. The need for protection is just as strong in the case of portfolio management, or arguably even stronger due to the fact that decision making is transferred to the investment firm.

4 Articles 19(1) and (4) of MiFID, and Articles 35 and 37 of the MiFID Implementing Directive.
5 Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC.

Therefore, the distinction should not be interpreted as meaning a lower level of protection in case of portfolio management services.

27. In case of portfolio management services, the client cannot be expected to have the same degree of knowledge and experience as someone who is taking his own decisions. Therefore, a distinction is justified. However, the same level of protection cannot be achieved only by making sure that the client "understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio". What is really needed is that the investment firm gain a very "clear understanding" and an "in-depth knowledge" of the profile of the client, of its psychology and of its investment strategy. Excellent understanding by the investment firm of the client is the key to making suitable investments.

28. In addition, in the case of portfolio management services, it is also essential to make sure that the client understands the risk profiles and financial implications of the products which a manager may make use of.

Paragraph 34

29. Regarding the extent of information to be collected, Paragraph 34 states that this includes "Other elements regarding the nature of the client, such as age, family situation or educational level may also impact the level of information to be collected".

30. The SMSG does not think that "educational level" is a good criterion to identify the ability of clients to understand financial relations and concepts. Holding a PhD in natural sciences or in literature, or even an MBA, does not represent hard evidence of ability to understand complex financial instruments, certain types of risks or just the principles of basic investing. Even clients that have studied economics might still need basic advice and help regarding their financial decisions. The informative value of this criterion might therefore be limited in practice and we suggest that it be removed. Alternatively, the Guidelines could state that this criterion should not be taken into account unless specific circumstances apply.

III.V. Updating client information

31. As mentioned by the Guidelines, "Article 37(3) of the MiFID Implementing Directive states that investment firms are entitled to rely on the information provided by their clients, unless they are aware or ought to be aware that the information is manifestly out of date. Firms' procedures should therefore define ... the circumstances to be taken into account in order to request additional or updated information". The Group would simply like to raise the issue of whether client information updating should remain at the discretion of investment firms, which is the current practice, or could take the form of formal ESMA Guidelines. This would provide a more consistent level of regulation but its possible content should also take into account the need not to overburden customers with too many requests.

III.VI. Arrangements necessary to ensure the suitability of an investment (Question 8)

Paragraphs 44-46 (Risk and loss sustaining capacity)

32. The Consultation Paper mentions that "In order to match clients with suitable investments, investment firms should establish policies and procedures to ensure that they consistently take into account: ... all characteristics of the investments considered in the suitability assessment, including all

relevant risks and any direct or indirect costs to the client". This recommendation is part of the "General Guideline" of the Draft Guidelines themselves (Paragraph 41). Paragraph 46 adds that a list of "Policies and procedures established by the firm should enable it to ensure inter alia that: (c) the financial situation of the client allows him to finance his investments at any moment and to bear any possible losses resulting from his investments". Point (c) is part of the "Supporting Guidelines" of the Draft Guidelines themselves (Paragraph 44).

33. The Group considers that mentioning "all relevant risks" in the "General Guideline" is not enough to protect investors. Investors, and especially retail investors, tend to underestimate the level of risk that they are taking as well as their own risk absorbing capacity. They realize that there is risk in the proposed investment but they might not evaluate correctly the probability of the realisation of the risk in certain circumstances. Risk is an overly abstract concept to govern suitability. Investors might also act in an over confident way by considering that they are better than other investors at assessing risks and will do better. In addition, the investment firm itself, in good faith, might also underestimate the amount of risk which is being incurred by the client. The recent financial crisis provides painful proof that many financial institutions and banks, although experts in risk assessment and equipped with sophisticated software and analysts, might take risks to a degree that they incorrectly analyse or simply underestimate risk. Therefore, as a whole, the mere indication to the client of the existence of "relevant risks" is not enough to provide adequate protection.

34. A more effective approach is to focus on the capacity of the investor to bear losses, which is mentioned as a criterion in the "Supporting Guidelines". There is strong support within the Group for giving much more weight to this criterion. This implies that loss capacity be at least used as a criteria in the « General Guidelines » as it is more concrete and accessible to retail investors. The loss sustaining capacity of an investor should be considered carefully, and in a practical manner. It should not be considered in an abstract way as currently mentioned in the "Supporting Guidelines". Potential losses should be understood through concrete examples, in proportion to the amount to be invested. For example: such as "How would you cope permanently with losing 10,000 euros on your 50 000 euros investments?". In addition, rather than mentioning "possible losses", the Guidelines could refer to "permanent losses" or at least "long term losses" in order to highlight the reality of loss bearing. Otherwise, an investor might simply anticipate that she will recoup her losses quickly. Long term losses could possibly be described by mentioning a five year period or by reference to a given time frame provided by the client regarding the duration of his investment.

35. If any loss of capital would have a materially detrimental effect on the standard of living of an investor, this should be taken into account in assessing the risk that she is able to take. The investment firm should take into account not only the risk that the investor is willing to take, but also the risk that she is able to take.[6]

Paragraphs 44-46 (age as a more specific criterion to ensure the suitability of an investment)

36. The criteria "age" is not mentioned specifically as a criterion to ensure the suitability of an investment. The Consultation Paper mentions that "In order to match clients with suitable investments, investment firms should establish policies and procedures to ensure that they consistently take into account: … "all available information about the client, including his current portfolio of investments

[6] See. FSA, Guidance consultation, Assessing suitability, Establishing the risk a consumer is willing and able to take and making a suitable investment decision, January 2011.

(and asset allocation within that portfolio), that is likely to be relevant in assessing whether an investment is suitable". This includes almost certainly "age". This is all the more that the Consultation Paper mentions the "age" of the investor as an information to be collected from clients (Part III.IV). Specifically, it mentions that "in many cases it is unlikely that a firm will be able to meet its obligations if it is unaware of, or fails to consider, the client's age" (Paragraph 22). It is also mentioned that "Other elements regarding the nature of the client, such as age, family situation or educational level may also impact the level of information to be collected" (Paragraph 34). However, the criterion of "age" is not singled out in the suitability assessment.

37. The Group notes that many issues of mis-selling concern elderly investors. For instance, a major case of mis-selling in the UK recently concerned customers who were typically in or near retirement.[7] While elderly people might be better investors than younger investors, or more cautious, the evidence shows that they can be also more fragile, less concerned by financial issues, or simply less experienced and aware of financial developments. Elderly investors also need more protection because they have less time to recoup losses, leaving them in a more difficult situation than younger investors. Finally, due to the current difficult situation with respect to public pension plans in Europe, there is a high probability that older people will look to invest their retirement savings to generate additional income in the coming years. Although investment firms would normally take the age of the investor into account, the Group is of the view that it would be wise to emphasise this criterion more strongly in the General Guidelines. For instance, the Draft Guidelines should also discuss age-related products, and in particular that the life span and investment objectives of a product make sense for the particular investor. A possible way to deal with the risks to of elderly investors would be to use a list of 'flags' which would trigger closer attention by the investment firm. If the advice seems not to fit with flag, then a second opinion from an higher hierarchical level within the investment firm might be required.

Paragraph 46 ("Conflicts of interest")

38. Paragraph 46 also mentions that "Policies and procedures established by the firm should enable it to ensure inter alia that: (e) any conflicts of interest are prevented from adversely affecting the quality of the suitability assessment". This point is also part of the Supporting Guidelines.

39. The issue of conflict of interest is especially sensitive when recommending investments or managing a portfolio. Therefore, the Group suggests that the Guidelines provide a more explicit explanation on how conflicts of interest should be prevented, rather than confine itself to a general comment on this point. This very important point with respect to conflicts of interest should also be made clearer and more practical. In order to do so, ESMA should collect, through its consultation process, concrete suggestions to how these "conflicts of interests" can be prevented.

III.VII. Record-keeping

40. The Group supports in principle the requirement that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment. However, such a requirement would place an additional burden on investment firms in terms of administrative capacity (cost, personnel allocated, time and technology needed for making such records). The phrase "all relevant information" is, therefore, too broadly formulated and might sug-

[7] See. FSA, Final Notice Barclays Bank Plc, 14th January 2011 available at *www.fsa.gov.uk/pubs/final/barclays_jan11.pdf*

gest that a great mass of data is to be recorded and stored, while only essential information might be generally necessary to be kept for the purposes described in Section III.IX "Record-keeping". One member of the Group suggested that, if so desired by the client, the investment firm should be able to avoid this obligation.

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

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