EV
EBF Ref.: D0223D-2012
Brussels, 24 February 2012

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF comments on ESMA guidelines on certain aspects of the MiFID suitability requirements

General Remarks

On diagnosis of the problem and remedial actions

The banking industry acknowledges and regrets the episodic occurrence of unsuitable investment recommendations. While we understand that the ESMA consultation paper is based on shortcomings observed by the national supervisors, we note, however, that the actual diagnosis of "investment suitability" is complex and one that involves the following elements:

- The clarity of suitability provisions
- The supervisory enforcement of those provisions
- The personal judgement of the advisor and his/her understanding of the rules
- Other biases, including ill-resolved conflicts of interest.

In this regard, the EBF would like to quote from a study[1] that ESMA mentions as an argument for further guidance in the area of suitability:

> *[The study goes on to note that the advisory engagement should not be viewed as a "checklist" of MiFID guidelines, having considered that the actual diagnosis of "investment suitability" is a complex and relatively cognitive process, subject to the advisor's own personal experience and judgement. It is foreseeable that an advisor might have fulfilled all the required MiFID requirements (from a process perspective) and yet fails to arrive at a suitable recommendation].*

The EBF supports this conclusion. While it is certainly important that existing rules are clear and that these rules are adhered to by advisors and enforced by supervisors, an improvement in the conduct of suitability assessment rests more with better judgement on the part of the advisors, a more proactive and open interaction between advisor and advisee and a satisfactory management of the potential conflicts of interest between the two.

[1] European Commission Market Study on Advice within the area of Retail Financial Services (see page 13), at: http://ec.europa.eu/consumers/rights/docs/investment_advice_study_en.pdf

EBF a.i.s.b.l
ETI Registration number: 4722660838-23
10, rue Montoyer B-1000 Brussels
+32 (0)2 508 37 11 Phone
+32 (0)2 511 23 28 Fax
www.ebf-fbe.eu

On the potential ultra vires nature of ESMA guidelines

It is true that, in developing detailed guidance on existing rules, ESMA is often unearthing and codifying existing market best practice. However, ESMA´s guidelines go in some aspects further than the MiFID Implementing Directive. For example, with regard to an investment firm´s obligation to always collect information regarding a client´s marital status or family situation or in connection to the obligation for investment firms to set up procedures that enable it to fulfil its obligations under the MiFID on an ongoing, consistent basis. Here, we would like to remind ESMA that its guidelines on suitability should be based on the principle of maximum harmonisation, in accordance with MiFID I.

Furthermore, it should be noted that best practice, by definition, is not so widespread. Divergence in practices also occurs geographically. While some EU Member States have a legal framework reflective of the guidance, others do not. As a result, we are of the opinion that, contrary to ESMA's appreciation, the draft guidelines will set out new obligations - on a comply or explain basis - and significant compliance costs for many firms where existing policies and procedures do not meet all aspects of the guidelines.

In this regard, we underscore the need to provide the EU industry with a reasonable timescale to carry out the necessary revision and implement the requirements in full.

On the potential side-effects of too detailed and intrusive requirements

An even more worrisome side-effect of the proposed guidance is the possibility that investor confidence in firms providing financial services is further weakened. It should not be forgotten that the relationship between the bank and its client is based on a mutual confidence and trust which implies a human part, i.e. a qualitative appreciation of the client's situation and needs. The EBF is of the strong view that confidence will not be earned back through the enforcement of too detailed and intrusive requirements for client information gathering, as the draft guidelines envisage. We believe that turning client profiling into an insurmountable barrier to access many financial products will drive many investors away from financial planning and investment and strengthened the perception that ranges of products are off-limits for all but the more sophisticated investors.

Furthermore, it should be ensured in any case that the new clarifications considered by ESMA do not create a windfall effect for clients, especially since they are being applied to an activity that is already highly regulated at European level, whereas other potentially more risky products (products permitting exposure to Forex or gold, for example) are now being sold by unregulated providers using sometimes very aggressive methods.

***

Finally, the EBF stresses in any case the importance of close coordination between ESMA and the European Commission to ensure that any potential changes required to these guidelines, following the review of the MiFID, are kept to a strict minimum.

Detailed remarks[2]

Concerning the background of the ESMA draft guidelines, we would like to highlight the following:

1. Concerning paras 8, 9 and 10, the difference between advice and portfolio management needs to be more clearly established. In case of portfolio management, the investment firm must assess whether the investment strategy with the chosen asset classes meets the investment objectives etc. In case of portfolio management, it is not the single financial instruments as mentioned in the draft, but a mandate on a range of products. We therefore suggest the following adaption of paras 8, 9 and 10:

   "8. 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,~~the recommended investment strategy is suitable for the client5 in question."

   "9. Accordingly, before providing investment advice or portfolio management services, investment firms must obtain the necessary information to be able to understand the essential facts about the client in order to assess the suitability of any investment, or investment strategy in case of portfolio management, for that client. This necessarily encompasses information about the client's:

      (a) investment objectives (including, where relevant, holding period, risk-taking preferences, risk profile and the purpose for which the investment is sought);
      (b) financial situation (including, where relevant, source and extent of regular income, in-vestments, other assets and financial commitments); and
      (c) knowledge and experience (including information to enable the firm to assess the client's ability to understand the risk involved in any transaction recommended or investment strategy recommended ~~undertaken~~ in the management of his portfolio)."

   "10. Based on the information collected, an investment firm is required to assess that the recommendation of the specific transaction to be recommended or, in case of ~~entered into in the course of providing~~ portfolio management service the recommendation of the specific investment strategy is suitable. Therefore, a firm must assess whether the recommended specific investment or investment strategy ~~decision~~ ~~involved~~ meets the in-vestment objectives, financial situation and knowledge and experience of the client in question. […]"

In para 11 the words "an ongoing" shall be deleted as they provide the false impression that the bank is at any time required to update the information to be provided by the client.

[2] Unless explicitly stated, paragraph number references are made to the main text and not to the Annex III (i.e. draft guidelines).

"11. To this end, an investment firm should adopt arrangements which enable it to meet the requirements of Article 19(4) of MiFID and Articles 35 and 37 of the MiFID Implementing Directive on a~~n ongoing and~~ consistent basis for any client […]".

Information to clients about the suitability assessment

Q1: Do you agree that information provided by investment firms about the services they offer should include information about the reason for assessing suitability? Please also state the reasons for your answer.

Para 17, last sentence states the requirement for investment firms to "recommend the most suitable product or service for the client." In our opinion this requirement is not covered by MiFID. We therefore suggest an amendment of para 17:

"17. […] Investment firms should highlight to the client that it is important to gather complete and accurate information so that the firm can recommend ~~the~~ ~~most~~ a suitable product or service for the client."

Furthermore, neither Article 19(4) MiFID nor Article 35-37 MiFID of the Implementing Directive state the requirement to establish a "risk profile" for a client. We, therefore, have concerns with para 18.

Furthermore, it is unclear what "steps" firms should take to ensure that the client understands the relationship between risk and return on investments. We recommend this idea to be deleted.

MiFID does not allow investment firms to decide on investment objectives, risk appetite etc. Therefore, and for the avoidance of doubt in order to avoid further liability consequences for investment firms in case of such guidelines, it should be clarified that:

(a) investment firms asses the suitability of the recommended product. In case the client should choose not to act in accordance with the recommendation and instead acquires another product, this investment would be the clients' own responsibility
(b) the client is responsible to provide investment firms with sufficient information on his investment objectives and risk appetite.

If an investment firms warns a client against buying a product or taking a service but the client finally decides to buy the product, such action is and remains the own responsibility of the client. Therefore, para 19 needs to be amended:

"19. It is the responsibility of the investment firm to assess the ~~The~~ suitability ~~assessment is the responsibility of the investment firm~~ of the recommendation/advice. In this regard, firms should avoid stating or giving the impression that it is the client who decides on the suitability of the recommendation investment, or that it is the client who establishes his own risk profile. It is a client's responsibility to provide correct, up-to-date and complete information for the suitability assessment (for example, by ~~indicating to~~ informing the investment firm about his investment objectives and risk appetite). A client can, under

his/her own responsibility invest in a way that is not in accordance with the recommendation".

Arrangements necessary to understand clients and investments

Q2: Do you agree that investment firms should establish, implement and maintain policies and procedures necessary to be able to obtain an appropriate understanding regarding both the essential facts about their clients, and the characteristics of financial instruments available for those clients? Please also state the reasons for your answer.

According to Article 19(4) MiFID the essential facts about an investment firms' client are his/her knowledge and experience, his/her financial situation and his/her investment objectives. So far, there is no requirement to always ask clients about their age, marital status, family situation, employment situation or need for liquidity. Clients are often unwilling to reveal their personal living situation. Details concerning "their level of education and profession or relevant former profession" (Art. 38(1)(c) MiFID Implementing Directive) are only rarely made. Indirectly these questions are already answered with the question concerning their financial situation (Art. 35(3) MiFID Implementing Directive). We therefore propose the deletion of para 22 sentence 2:

"22. Investment firms should know their clients. This means that firms should implement policies and procedures that enable them to collect, for example through questionnaires completed by their clients, and assess all information necessary to conduct a suitability assessment for each client. ~~For example, 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, marital status, family situation, employment situation, or need for liquidity in certain relevant investments.~~"

Qualifications of investment firm staff

Q3: Do you agree 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? Please also state the reasons for your answer.

Yes. However, the level of skill and expertise may vary depending on the clients segment (e.g. mass retail versus more sophisticated, high net worth private banking clients) and the product offering to such clients.

Extent of information to be collected from clients (proportionality)

Q4: Do you agree that investment firms should determine the extent of information to be collected about the client taking in to account the features of the service, the financial instrument and the client in any given circumstance? Please also state the reasons for your answer.

Whilst it is true that "firms should know their clients" we are of the view that firms should not be expected to encourage their clients to reveal certain aspects of their personal and financial

circumstances. Firms should be allowed to exercise proportional discretion as to what information is necessary. In this regard, the exemplary content of the guidance is too comprehensive, particularly in connection to restrictions on a client's assets, for example. Clients' capacity to financially bear risks will only in very rare instances depend on such restrictions. Furthermore it seems unclear how "risky and illiquid financial instruments" is defined as this is not a definition from MiFID I.

Furthermore:

- With regard to para 26, it should be clarified that "necessary information" is the information necessary considering the nature of the service provided cf. MiFID Directive Level 2 Article 35(1).

- Para 29, letter b: We oppose references to "pension funds" and the enumeration in brackets. They do not appear explicitly in Article 35 (3) of the MiFID Directive Level 2.

- Para 29, letter c: Although information on future plans and commitments may be relevant, rarely is such information concrete enough at the point of the recommendation to be properly assessed. We would recommend that the reference is made to "quantifiable" future plans and commitments.

- Para 33 distinguishes between 'per se professional clients' and "other professional clients". Although this distinction follows from Article 35.2 of the Implementing Directive, the distinction here adds no value and the example regarding hedging is not so relevant (i.e. it is part of the investment service and not of the suitability assessment to be carried out as a result o that service). For those reasons, we recommend the deletion of the last two sentences of para 33:

  > *"33. Similarly, where the investment service consists in the provision of investment advice to a 'per se professional client' the firm is entitled to assume that the client is able to financially bear any related investment risks consistent with the investment objectives of that client and therefore is not generally required to obtain information on the financial situation of the client.* ~~*Such information will be required, however, where the client's investment objectives demand it. For example, where the client is seeking to hedge a risk, the firm will need to have detailed information on that risk in order to be able to propose an effective hedging instrument."*~~

- It seems unclear how "short- term secure investments" (para 35) are defined. This is not a MiFID I definition.

- It should be noted that the determination of the extent of information to be collected may conflict with EU data protection regulation or other circumstances.

Finally, para 36 states that firms that do not obtain "sufficient information" must refrain from providing any service to a client. The current legal text stipulates that it is the client's refusal to

produce information that results in the firms not being allowed to provide the service. The client's refusal is an objective parameter whilst the sufficiency of information is not. Consequently, to avoid any misunderstandings, we would recommend that this section of the guideline is deleted.

Reliability of client information

Q5: Do you agree that investment firms should take reasonable steps (and, in particular, those outlined above) to ensure that the information collected about clients is reliable and consistent? Please also state the reasons for your answer.

We have reservations on potential obligations on firms to ensure certain characteristics about the information provided. According to Article 37(3) of the Level 2 Directive, an investment firm shall be entitled to rely on information provided by its clients or potential clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete. It should, therefore, be clear that the client is providing information that the investment firm, as a rule, can rely on. That is not to say that the firm can rely on the client's "self-assessment" alone. A firm should not unduly rely on the clients' self-assessment of his knowledge, experience and financial situation. We therefore ask you to insert the word "unduly" in the guidance contained in para 32(a).

As a consequence of the above, para 36 is a matter of concern. Firms would be asked to "view the information collected as a whole" to "resolve any potential inconsistencies". Whilst firms accept a duty to reasonably ensure that the information provided is accurate, such a duty should not be extended to also include passing judgement on potential inconsistencies and /or mandating firms to resolve those inconsistencies. We would kindly request ESMA to amend this guideline.

Updating client information

Q6: Do you agree that where an investment firm has an ongoing relationship with the client, it should establish appropriate procedures in order to maintain adequate and updated information about the client? Please also state the reasons for your answer.

Yes. This is a reasonable requirement in order for the firms to know their clients. However, where an investment firm has an ongoing relationship with the client consisting in the provision of investment advice and there are no objective reasons known to the investment firm to update the client information, the update should not be carried out more frequently than annually. In addition, clients are obliged to inform the service provider about relevant changes in their circumstances.

Client information for legal entities or groups

Q7: Do you agree that regarding client information for legal entities or groups, the investment firm and the client should agree on how the relevant client information will be determined and, as a minimum, information should be collected on the financial situation

and investment objectives of the beneficiary of the investment advice or portfolio management services ('end client')? Please also state the reasons for your answer.

We agree with ESMA that information on the financial situation and investment objectives should in theory be on the beneficiary(ies) of the investment advice or portfolio management services (i.e. 'end client'). However, it is often the case that investment firms do not have contractual relationships with the beneficiaries but, rather, with their clients (i.e. the legal entity). Often in these cases only a single assessment is made involving the Chief Financial Officer (CFO), who then allows or disallows a delegation of authority for placing orders to another person in the company. This delegation engages the responsibility of the delegator. In other situations, if the client so desires, it may happen that two or more corporate officers are assessed. Likewise for trusts. This results in banks not collecting detailed information on the financial situation of the beneficiaries, as responsibility for the beneficiaries lies with the appointed responsible at the legal entity.

As a result, no schema should be imposed in this area, which is intimately related to the bank/client relationship and to the size of the legal entity. Moreover, knowledge of the client can never extend to 'end clients' if the investment firm does not know them. In particular, when the client is an investment fund, it is important to clarify that the 'end client' is the fund in question and not its holder(s).

As regards the "knowledge and experience" for legal entities, the investment firm would again relate to the designated employee.

With regard to groups of natural persons that have not appointed a representative, the advice must be deemed suitable for all persons in the group. Concerning the level of knowledge, in a group with no representatives, firms should probably settle for the level of knowledge and experience of the less experienced person in the group. This general rule may need to take into account particular circumstances, for example, where a non-appointed representative is known to behave as a "de facto" decision maker or in the case of two partners that invest their monies via a joint account, where it might be appropriate to cumulate both their knowledge and experience for the purposes of testing suitability on joint account level.

Arrangements necessary to ensure the suitability of an investment

Q8. Do you agree that in order to match clients with suitable investments, investment firms should establish arrangements to ensure that they consistently take into account all available information about the client and all characteristics of the investments considered in the suitability assessment? Please also state the reasons for your answer.

We have concerns with all investment firms being asked to establish arrangements to ensure that they consistently take into account certain data. Reasons:

- this is not currently required by Article 35 of MiFID Directive Level 2;

- this implies a discretionary, strategic decision to provide investment advice based on suitability assessments not related to each individual investment, but rather to the entire portfolio;

We also think that paragraph 46 (a) could better clarify that an appropriate degree of risk diversification is crucial. This is strongly related to many factors (such as size of the client's portfolio, risk management policies, nature and characteristics of investment products, decreasing reliability of rating agencies) that only intermediaries can properly define.

We are, furthermore, concerned that the guidance could be interpreted as an implicit obligation for the firm to perform an "ongoing suitability assessment". The evaluation of suitability must be based on the situation where investment advice is provided. The future changes shall be taken into account if and when there is a new evaluation due to the client's request or firms own initiative. Different credit limits or market risk controls should be adequate to ensure that the client is capable of bearing the risk of investments on regular basis. Consequently, the guideline could be amended to further clarify that the use of the established arrangements to take into account all available information would only be triggered while episodically assessing whether a given investment is suitable.

Furthermore, in para 45, the guidance should specify what is meant by "classify broadly".

Finally, the obligation that would be placed on the investment firm to take into account in the suitability test all information regarding the client is inconsistent with point 31 of the consultation paper, according to which the level of detail required by the investment firm can vary, depending upon the extent of the service provided to the client. The current provisions of the MiFID also provide that the investment firm must obtain from its client any information necessary for and relevant to the specific type of product or service concerned.

Record-keeping

Q9: Do you agree that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment? Please also state the reasons for your answer.

The investment firms already have record-keeping arrangements covering the information concerning the suitability assessment. However, the extent of information to be collected may conflict with EU data protection regulation or other circumstances.

We note, furthermore, that in the first bullet point of the guideline, there is a reference to "all stages". We are of the view that the focus should rather be on specific stages, such as the receipt of information and the outcome of the suitability process. Firms cannot possibly record all stage of the suitability test.