Response to ESMA consultation: ESMA35-43-748

Guidelines on certain aspects of the MiFID II suitability requirements

Response by:

2° Investing Initiative, International non-profit think tank

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Endorsement of response by:

Sirpa Pietikäinen, Member of the European Parliament

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Dear Sir or Madam,

We are delighted to have the opportunity to provide input on the ESMA's consultation regarding *guidelines on certain aspects of the MIFID II suitability requirements.*

Please find our suggestions for the review of the guidelines below. The following suggestions are also officially endorsed by Sirpa Pietikäinen, Member of the European Parliament.

Yours sincerely,

Thomas Braschi

Q2: Do you agree with the suggested approach on the arrangements necessary to understand clients and specifically with how the guideline has been updated to take into account behavioural finance and the development of robo-advice models?

1) THE NON-FINANCIAL INVESTMENT OBJECTIVES ARE NOT INCLUDED IN SUITABILITY QUESTIONNAIRES – DESPITE THESE BEING IMPORTANT TO A MAJORITY OF CLIENTS

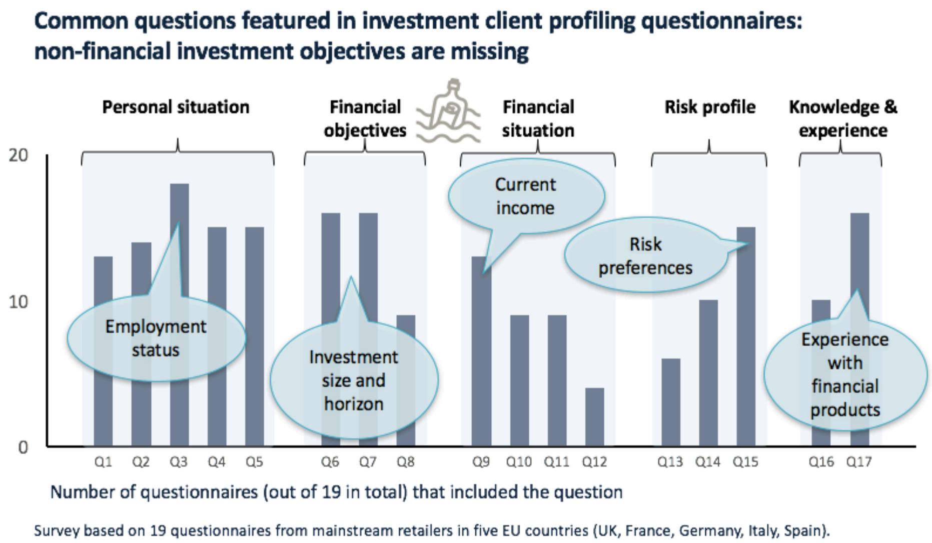
Non-financial investment objectives are an important aspect for understanding clients:

Non-financial investment objectives are playing an important role for a large majority of retail investors according to industry-led surveys among retail clients. According to survey results published by Natixis Global Asset Management[1] around 70% of retail investors view 'non-financial' factors (i.e. environmental, social, ethical impacts associated with their investments) as important factors for their investment decision-making. The level of interest is specifically high for the younger generations.

There is not sufficient information on how the importance of non-financial investment objectives relates to financial investment objectives and what kind of trade-offs (if any) clients would be willing to accept in order to achieve their non-financial objectives, if this was necessary. However, it is clear that in order to fully understand the client and his objectives and to propose suitable investment products, these issues would need to be discussed.

Currently non-financial investment objectives are not discussed by financial advisers:

Research on current practices of financial advisers in Europe and questionnaires used for suitability assessments clearly indicates that the non-financial investment objectives are rarely ever discussed.



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

If they are discussed (because the client specifically raises these objectives), these preferences are not recorded together with the rest of the information that results from the suitability assessment, as such questions are not foreseen in the design of the questionnaires.[2] Not recording such preferences together with the rest of the client information makes it difficult for ex post assessments to identify if the products proposed where suitable for the client also with regard to his non-financial investment objectives.

Given that the suitability assessment is already a highly structured process, the implicit exclusion of non-financial investment objectives is highly likely to create behavioural biases related to « frame dependence and anchoring »: clients may not spontaneously add these objectives to the discussion if they perceive the process as being pre-structured and their individual preferences as not fitting in this norm.

This unexpressed demand has wider consequences on product design and adviser training.

Financial advisers are an important source of information on the actual (and not only stated) demand of retail clients. Not including the discussion of non-financial investment objectives also presents a major obstacle to improving the flow of information on client preferences to product managers and very likely leads to a sub-optimal product choice available to the client.

In addition, while training offers for financial advisers related to sustainable investment exists[3], few advisers receive such trainings to date. Revealing that a strong demand among clients exists, would give such training higher priority and enable financial advisers to adequately respond to the client demand.

MIFID II allows the integration of non-financial investment objectives, but more clarity is needed

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

[2] The research covered the analysis of 19 questionnaires used in mainstream institutions in France, Germany, Italy, Spain and UK) and findings were confirmed in telephone interviews with 6 industry associations in France, Germany, Luxemburg, Netherlands and Spain. For a detailed discussion see : http://2degrees-investing.org/IMG/pdf/retail_savings_final.pdf

[3] e.g. the Sustainable Investment Training Course, funded by the EU commission Life Learning Programme.

The wording to the MiFID II Directive and delegated regulation already allow to integrate questions on non-financial investment objectives in the suitability assessment. The term "investment objectives" is not further specified and thus could include financial as well as non-financial investment objectives.

An analysis of the transposition documents in a number of key member states has revealed that member states have chosen not to define investment objectives in much more detail. When this is the case the terms used mostly are "purpose of the investment", "investment horizon" and "risk preferences".[4] It can thus not be expected that the implementation of MiFID II will lead to the integration of the client's non-financial investment objectives unless this point is clarified in the ESMA guidelines on certain aspects of suitability requirements.

We recommend to include a clear reference to non-financial investment objectives in the guidelines

For example, the guidance could be amended in the following way (proposed changes to the text are written in blue):

"Arrangements necessary to understand clients (…)

Supporting guidelines (…)

26. Information necessary to conduct a suitability assessment includes different elements that may affect, for example, the analysis of the client's financial situation (including his/her ability to bear losses) or investment objectives (financial objectives including his/her risk tolerance, as well as non-financial objectives). Examples of such elements are the client's:
    a) Marital status (…);
    b) family situation (…);
    c) age (…);
    d) employment situation (the fact that the client might lose his/her job or is close to retirement may impact his/her financial situation or its financial investment objectives);
    e) the need for liquidity in certain relevant investments;
    f) Personal preferences related to the environmental and/or social impacts of investments, including for instance the willingness to invest in ways not consistent with climate policy goals.
27. The assessment of preferences regarding environmental or social impacts should include questions about the willingness to invest in entities that run strategies inconsistent with the client's objectives, the use of shareholder rights to support and/or influence the management of these entities, and the trade-off that the investor is willing to make to prioritize social or environmental outcomes. The assessment will at least confirm the intention of the client vis-à-vis the support of the implementation of the Paris agreement. New ESMA Q&A on investor protection will be issued to provide further guidance and include definitions of relevant concepts."

In addition, in order to shed more light on the actual consumer demand and to develop clear guidance in this new and relatively undefined field, we recommend the following:

a) **conduct surveys and focus groups** to better understand the level of interest of European retail investors and their willingness to accept trade-offs in case these exist,

[4] For a detailed discussion see : http://2degrees-investing.org/IMG/pdf/retail_savings_final.pdf

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

2) FUTURE DEVELOPMENTS OF SUITABILITY QUESTIONNAIRES LINKED TO INCREASING DIGITALISATION AND USE OF ROBO-ADVICE

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

With the increasing substitution of robo-advice for traditional financial advisors, the suitability assessment process is likely to change dramatically:

- The shift to online questionnaires will enable a more sophisticated structure of questions, while not increasing the complexity nor the duration of assessments. For instance, if the client responds positively to a question about his/her willingness to pursue social or environmental objectives, an online questionnaire can trigger another question asking for details. Similarly, an online questionnaire can allow testing of different scenarios about the trade-offs a client is ready to make.
- Such a questionnaire would likely lead to the collection of more information on the client's preferences, including multiple data points that can be turned into investment criteria (e.g. willingness to exclude companies that produce weapons, support the alignment of investment plans with climate goals through the use of shareholder votes, etc.). Combined with a 'product scanner' function and the availability of related information on investment products, robo-advice can therefore allow the integration of multiple complex non-financial criteria into the decision-making process.

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

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

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

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

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

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

Concretely, a number of labelling schemes for funds (e.g. Climatrics rating by CDP[5], Sustainability Ratings for funds by Morningstar[6]) have been recently introduced. Besides, when the composition of funds is available, in most cases it is possible to use multiple sources of social and environmental information on securities to assess the exposure of funds to various business activities and issues. The information currently available in combination with 'product scanners' therefore allow retailers to associate each product with its sustainability features and match them with the clients' social and environmental criteria.

2° Investing Initiative will be developing a pilot "product scanner" for the German market starting at the end of 2017. The product scanner will be available for free to clients and financial institutions alike and will be using various sources of information, including those available to the market as well as internal analysis. The project is funded by the German National Climate Initiative (NKI) and could provide valuable insights for future regulation on product information needs and client preferences. 2° Investing

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[5] **Climetrics** (CDP) Using the most advanced metrics available, Climetrics has developed an independent, rules-based and transparent methodology to communicate the overall climate impact of investment funds. The methodology was developed by the ratings data providers CDP and ISS-Ethix Climate Solutions in consultation with NGOs, asset owners and managers as well as members of the academic community. Also including a number of external data sources, it scores funds across three levels to produce its 1-5 green leaf rating. Climetrics covers roughly 55 percent of the assets invested in equity funds that are currently for sale in Europe, representing about €2 trillion in fund investments.

[6] The Sustainability Rating™ (Morningstar) is a measure of how well the holdings in a portfolio are managing their ESG risks and opportunities. The rating is a holdings-based calculation using company-level ESG analytics from Sustainalytics. It is calculated for managed products and global indices using Morningstar's portfolio holdings database.

Initiative will reach out actively to regulators and financial institutions to become involved in the project with the aim to insure that the outputs of the project are adapted to their information needs.