



ADVICE TO ESMA

SMSG advice to ESMA on its Consultation Paper on “Guidelines on certain aspects of appropriateness and execution-only”

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 investors. The SMSG takes a positive view on the approach of building on relevant parts from ESMA’s Guidelines on certain aspects of the MiFID II suitability requirements, adjusting them to the appropriateness and execution-only framework. It also remarks, however, that MiFID II foresees different regimes, and that these differences should find a balanced consideration in the present GLs.
2. That having been said, given the nature of non-advised services subject to this framework, further adjustments should be envisaged, for example regarding the update of client information. The SMSG is of the opinion that it is important that the right balance is kept between a high level of investor protection and the availability of products for clients who buy on their own initiative.
3. The SMSG appreciates that the GLs take into account the results of the common supervisory action (CSA) on appropriateness conducted by national authorities. However, the SMSG observes that the CSA is not available to the public, and therefore suggests that at least the main findings of this and, as a general rule, future actions are made public.
4. The SMSG acknowledges the efforts made, particularly in guideline 8, to improve the consistency at firm level of the qualification of clients and subsequent matching with products. The SMSG fears, however, that the present guidelines cannot guarantee consistency of qualification of clients and subsequent matching with products and services across firms. The SMSG therefore encourages ESMA to perform a peer review aimed to detect best practices.
5. Finally, given the increasing automation in the assessment, the SMSG finds the introduction of guidelines dedicated to the consistency of these automated tools particularly useful.
6. Additionally, the SMSG also has a number of remarks:
 - First, the SMSG believes that a balance should be struck between the legitimate need to inform and the clarity and accessibility of information. For this purpose, the SMSG proposes that whenever possible the information to clients might be provided in standardised form. For instance, to improve the clarity the SMSG proposes that ESMA presents a standardised template specifying the difference in protection in advised and non-advised services.

- Second, given the nature of the relationship firms have with clients when offering non-advised services, the SMSG is sceptical of a strictly prescriptive approach (e.g. limiting the number of attempts or imposing a cooling off period in the case of assessment retakes; updating clients' information without a consistent motivation). In this respect, it acknowledges the importance of prominent, effective, and intelligible warnings as a way to prevent possible harmful transactions.
 - Third, the SMSG has a general concern with the concept of “more complex products” as mentioned in the CP and does not agree with the introduction of a further classification of complex products according to lower and higher levels of complexity, unless clearly specified. A simple mention of “more complex” products leaves ground to heterogeneous interpretations to the detriment of investor protection. The SMSG advises ESMA to delete the distinction and, if ESMA is of the view that further distinction of product complexity is required, existing GLs regarding complex products should be amended and updated accordingly.
 - The SMSG advises to clarify that the assessment of knowledge and experience “*of a specific type of product*”, should take into consideration these specificities.
 - Finally, the SMSG fully recognises the importance of sustainable finance, but believes it is necessary to avoid the risk of ‘overshooting’, which could undermine the credibility of both the appropriateness test and sustainability goals. It is not aware of any evidence that ESG products exhibit risk/ reward profiles materially different from conventional products to such an extent that sustainability risks and factors should be incorporated in the appropriateness test.
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I. Background

1. On 29 January 2021, ESMA launched a consultation paper on “Guidelines on Appropriateness and Execution-only”, pursuant to the legislative framework set out in article 25(3) of MiFID II and Article 55 and 56 of the MiFID II Delegated regulation (as regards the appropriateness requirement), as well as Article 25(4) of MiFID II and Article 57 of MiFID II Delegated Regulation (as regards “the execution-only” exemption). 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 the SMSG of 24 March 2021.

II. Comments on the Scope and on different questions in the consultation paper

Scope and general comment

1. P.23, para 1.(b): The SMSG advises to replace “Investment Firms” with “Firms”. This change is consistent with the definition provided on p. 24 and the definition employed in the GL on suitability. It clarifies that credit institutions providing investments services are included in the scope.
2. The SMSG observes that guidelines are often not respecting gender neutrality when mentioning investors or their characteristics (e.g. p.30 para 32 “his ability”). The SMSG strongly supports the revision to a gender neutral rephrasing of the guidelines. In English, this could be implemented using “s/he or they or it” and equivalent formulations can be found in all EU languages the GL are translated into.

Q.1: Do you agree with the suggested approach on providing information about the purpose of the appropriateness assessment?

3. The SMSG in general welcomes the suggested approach and agrees that it is necessary to inform clients of the purposes of the appropriateness assessment, but nevertheless has a number of comments.
4. P.25, para 13: With specific reference to the “clear and simple” information to clients, the SMSG highlights that if clients operate in countries where more than one official language is spoken, firms should ensure that the above mentioned information is provided in the preferred language of the clients.
5. P.25-26, para 14:
 - Second bullet: ESMA indicates that in case of no assessment, firms should inform clients of the consequences. The SMSG believes it is necessary to enhance the clarity and the effectiveness of any warnings and of any statements regarding the firm’s responsibilities in the case of non-advised services. The SMSG advises ESMA to request that firms specify the “consequences” and the lack of “protections” (also GL 9, para 65, p. 37) in case they are unable to assess appropriateness due to lack of sufficient, accurate or reliable information from clients”.
 - Last bullet: whereas it is important that clients be aware of the differences between advised and non-advised services, the SMSG is of the view that it would be possible to achieve that objective by simply including a statement informing clients that “firms are not providing advised services and do not assess clients’ financial situation, nor her/his investment objectives”. Additionally, with the aim to improve the awareness of clients on the different degrees of protection they receive within the perimeter of advised and non-advised services, the SMSG proposes that ESMA presents a standardised template specifying the main differences in protection between the relevant (advised or non-advised) investment services to hand to clients. Finally, with the same aim, the SMSG suggests to re-introduce a paragraph equivalent to para 16 of the GL on suitability¹ modified to match the appropriateness and execution-only requirement.
 - The SMSG notices that the guideline, different from the equivalent GL on suitability (p.35, para.15), does not mention the possibility that such information could be provided in a standardised form. The SMSG believes that easily accessible information is crucial and so suggests to introduce this statement in the present guideline as well.

Q.2: Do you agree with the suggested approach on the arrangements necessary to understand or warn clients?

6. The SMSG in general welcomes the suggested approach. It nevertheless has a number of comments.
7. P.26, Para 18: ESMA states the need to implement and maintain adequate policies and procedures to ask clients the relevant information and the supporting guidelines specify this requirement. The SMSG agrees with the general framework, but points out that a paragraph should be included requiring firms to have in place policies and procedures aimed at (i) assessing the quality of different

¹ “information about the suitability assessment should help clients understand the purpose of the requirements. It should encourage them to provide accurate and sufficient information about their knowledge, experience, financial situation (including their ability to bear losses), and investment objectives (including risk tolerance). Firms should highlight to their clients that it is important to gather complete and accurate information so that the firm can recommend. Without this information, firms cannot provide investment advice and portfolio management services to clients

means of asking clients for information on their knowledge and experience and (ii) controlling whether these means are fit for purpose.

8. P27-28, Para.22 and 25: comparing the current guidelines with those on suitability, the SMSG sees positively the confirmation of guidelines regarding policies and procedures aiming to reduce the risk of clients failing to answer correctly presented in para.22 (equivalent to para.25 P.37 GL on suitability) and the introduction of para.25 presenting new – compared to the suitability GL – requirements on policies and procedure to reduce the risk of self-assessment
9. P. 27, Para 23: the SMSG agrees with the general requirement that firms should have procedures to limit the risk that information collected from clients who changed their answers to a questionnaire after a first attempt to respond, would not be reliable. However, given the nature of the relationship firms have with clients when offering non-advised services, the SMSG believes that allowing to limit the number of attempts and to impose a cooling-off period could lead to the development of different practices amongst market participants. The SMSG would therefore prefer less far-reaching measures. Indeed the possibility to reduce the risk of circumventing the requirement could be implemented with less paternalistic policies and procedures such as the possibility to work with different sets of questionnaires after a first “wrong attempt” and/or the use of different means to ask for the information.

Q3: Do you agree with the suggested approach on the extent of information to be collected from clients?

10. The SMSG agrees that complexity is a relative term (para 53 p.34) and believes that a possible specification of different levels of complexity should be made taking into consideration the firm’s analysis conducted for the purpose of its product governance obligations (i.e. target market of end clients with respect to knowledge and experience). However, the SMSG has a general concern with the concept “more complex products” as mentioned in the consultation paper (GL 3 para. 32, 33 on p.30 and GL 7 para. 53, 54 on p.34-35). Both art. 25(4) MiFID II and art. 57 of the Delegated regulation make a distinction between complex and non-complex products. In addition, the Guidelines on complex debt instruments and structured products, issued by ESMA in November 2015, clarify which products could be defined as complex for purposes of the execution-only exemption. The SMSG does not agree with the introduction of a further classification of complex products according to lower and higher levels of complexity, unless clearly specified. A simple mention of “more complex” products leaves ground to heterogeneous interpretations to the detriment of investor protection. The SMSG advises ESMA to delete such a distinction, unless a better explanation would be included. In this regard, if ESMA is of the view that further distinction of product complexity is required, existing GLs regarding complex products should be amended and updated accordingly.
11. P.30 para 33: consistently with the comments in the previous paragraph, and based upon the opinion that the appropriateness assessment is not aimed at the evaluation of the general knowledge of a client of a category of products, but, as art.25(3) of MiFID II states, “*of a specific type of product*”, the SMSG believes that a major objective of the appropriateness assessment is to evaluate whether the clients understand (knowledge and experience) the risks embedded into financial instruments and services. The SMSG therefore suggests to change the wording of this paragraph as follows: “*The firms should assess the client’s knowledge and experience not solely on the basis of the general type to which the product belongs but also taking into account an adequate specificity referencing the appropriate ESMA guidelines (e.g. the impact of subordination on the return of debt instruments as in the November 2015 guidelines on Complex debt instruments and structured deposits (ESMA/2015/178)*”.
12. P.30 para 35: the SMSG agrees with the accompanying guideline presented in this paragraph. However when a client receives both advised and non-advised services s/he might not be fully aware of the different rules of conduct the firms need to comply with. Therefore, the SMSG suggests

to modify the second sentence as follows: “Firms **should clearly specify** to clients that only information regarding knowledge and experience is taken into account when conducting the appropriateness assessment and that other information collected for other purposes (i.e. in the context of advised services to the same client), including, in particular, information regarding the client’s financial situation and/or investment objectives, will not be used for the assessment”. The SMSG notes that firms should at all times observe the principles of “data minimization” and “purpose limitation” as set out in items (b) and (c) of art. 5(1) of GDPR and advises to add a sentence to that effect at the end of para. 35.

Q.4: Do you agree with the suggested approach regarding the appropriateness assessment relating to a service with specific features (paragraph 34 of the Guidelines)? In particular, do you agree with the examples provided (bundled services and short selling), or would you suggest including other examples?

13. The SMSG agrees with the suggested approach and believes it is fully consistent with art.25(3) of MiFID II, mentioning bundled products or services. Indeed as pointed out in art.24(11), the risk resulting from bundling can be different from the risk of investing in individual components taken separately (e.g. provision of loans). The SMSG agrees with the examples provided in para. 34 on p. 30.

Q.5: Do you agree with the suggested approach on the reliability of client information?

14. P. 31, para. 36: the SMSG notes that this guideline seems to go beyond both art.25(3) of MiFID II and art. 55(3) of the Delegated regulation, as the latter states that “an investment firm shall be entitled to rely on the information provided by the clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate and incomplete”. The SMSG believes that firms can by default rely on the information provided by clients and it is not their responsibility to thoroughly challenge the information received by clients, unless manifestly outdated, inconsistent, inaccurate or incomplete. The SMSG therefore suggests to re-write this paragraph as follows: “Firms should take reasonable steps, including the adoption of appropriate tools, to ensure that the information provided by clients is reliable and consistent...”.
15. P.31, para 38: the SMSG agrees with the general proposition and believes that firms should take special care when the information is collected making use of automated tools, such as “profiling software”. The SMSG advises to insert a reference to para. 63 into this guideline to ensure that the requirements for the use of automated tools are applied *mutatis mutandis*. Moreover, this guideline should specify that “firms should a) inform clients, without prompting, that profiling will be carried out by automated software tools, and b) upon request, explain to clients the functioning of the automated tools before the assessment takes place”.

Q.6: Do you agree with the suggested approach on relying on up-to-date client information?

16. P.31, para 41: the SMSG agrees with the consideration that knowledge and experience are less volatile and normally increase over time. The appropriateness assessment therefore requires, in principle, less updates than the suitability assessment, even though special attention should be given to more vulnerable groups. Several studies have shown that cognitive decline is a possible source of declining financial literacy (e.g. Agarwal et al 2009 and Finke et al 2017)². In the light of

² Agarwal, S., J. C. Driscoll, X. Gabaix, and D.Laibson. 2009. The age of reason: financial decisions over the life-cycle with implications for regulation. Economic Studies Program, The Brookings Institution, vol. 40(2 (Fall)), pages 51-117; Finke, M.S.,

this, and in the absence of a legal requirement to make a distinction between “less vulnerable” and “more vulnerable”, the SMSG proposes to change the last sentence as follows: “Firms should develop a policy to assess knowledge and experience of groups that are deemed more vulnerable on a more regular basis”. Additionally, the SMSG suggests to delete the footnote, since the reference to older clients could be considered discriminatory.

17. P.32, para.42: the SMSG wishes to nuance the introduction of this paragraph and the request to periodically update the information regarding the knowledge and experience of clients. The SMSG remarks that, differently from advised services where the update is crucial for the assessment of suitability, periodic updates of client information is not always relevant for execution services, since, in some cases the client does not have a long term relationship with the firm providing non-advised services. In case of a one-off transaction, the client will only answer questions before executing that transaction and no updates will be needed.
18. P.32, para 45: the SMSG fully supports the proposed guideline that firms should adopt measures to mitigate the risk of circumventing the requirements of a veritable assessment of the knowledge and experience of clients. Since clients execute orders with different frequency (e.g. day traders vs occasional investors) the SMSG suggests to modify part of the paragraph as follows: “ *An example of a good practice to address this type of risk is that a firm could adopt procedures to verify, before and after transactions are made, whether, given clients’ transactions, anomalous updates (i.e. too frequent and/or too close after a previous update) took place.*”

Q.7: Do you agree with the suggested approach on client information for legal entities or groups?

19. The SMSG has no comments in this respect.

Q.8: Do you agree with the suggested approach on the arrangements necessary to understand investment products?

20. P.34-35, para.53-54: see para.10 of the present advice
21. P.35, para. 55: The SMSG fully supports that there is a need for investor protection in self-directed mode of investment, notably considering product complexity. The SMSG believes that high standards of investor protection should not be in contrast with the availability of a wide range of products that self-directed investors can choose from. The SMSG supports that firms should consider adequate granular factors for the categorization, but it fears that the examples provided are too far going for that purpose and believes that a different classification consistent with product complexity would be more effective.

J.S Howe, J.S. and S.J. Huston, S.J. 2017. Old age and the decline in financial literacy. *Management Science*, 63(1), 213-230.

Q.9: Do you agree with the suggested approach on the arrangements necessary to assess the appropriateness of an investment or else issue a meaningful warning?

22. The SMSG agrees with the proposed guidelines and believes it is important and useful to ensure consistency in the qualification of the knowledge and experience of clients and in the subsequent matching with the appropriate products and investment services. Given the increasing automation in that process, the SMSG finds the introduction of a paragraph (63) dedicated to the consistency of automated tools used in the appropriateness assessment particularly useful.
23. P.36-37, para. 63: the SMSG suggests to incorporate some additional considerations to take account of the fact that automated software tools using so-called “machine-learning” algorithms are expected to be increasingly deployed in the financial sector. Due to the dynamic nature of these tools it is imperative that they are a) properly documented and explained to enable regular reviews by third parties, including supervisors; and b) regularly tested.

Additionally some members believe that it is important that algorithms are also benchmarked to demonstrate the stability of the algorithm, both cross-sectionally, across different datasets, and intertemporally, against the same reference data. They suggest that in the first bullet the requirement for algorithms to be monitored and tested should be amended accordingly (“monitored, tested and benchmarked”) and that in the third bullet the required test strategy should explain the scope of “testing and benchmarking” of algorithms. Other members note that GDPR sets out the appropriate regulatory framework for the use and control of such automated decision-making tools and consider that any additional ESMA guidelines in this area should not create new obligations for firms that already duly implement this regulation on personal data.

To further improve the transparency of the assessment process for clients in cases where the process is largely automated, the SMSG advises to add an additional para. 63a obliging firms to

- inform clients ex-ante that automated tools are being used in the appropriateness assessment;
- make arrangements so that clients may, upon request, have access to a qualified member of staff to obtain an explanation of how the assessment has been made; and
- allow the client to request a review of the outcome of the assessment by a qualified member of staff.

Q.10: Do you agree with the suggested approach on the effectiveness of warnings?

24. The SMSG agrees that it could indeed be useful to promote greater convergence of warnings, as currently the statements tend to be fairly heterogeneous. The SMSG appreciates the introduction of insights of behavioural economics to make warnings more salient (para. 65) and more adequate to reduce inertia and instinctive and less rational³ behaviours (para.68).
25. P.37, para 65: the SMSG would recommend to add a requirement for warnings to be prominent. Additionally it remarks that the current formulation of the first sentence: “firms should take reasonable steps to make sure the warnings issued to clients are correctly received and understood as such” seems to suggest that firms may be considered liable for a correct reception of warnings or

³ System 1 behaviours as defined in Kahneman D. (2001) “Thinking fast and slow”, Farrar, Straus and Giroux

for their understanding, although such requirement does not follow from L1 and L2. In these respects, the SGMG advises that the first sentence of the paragraph be amended as follows: *“Firms should ensure that the warnings they issue to clients, if communicated online or in writing, are prominently displayed. Firms should formulate these warnings clearly and in a plain language to enhance clients’ correct comprehension”*

26. P.37-38, para 66: the SMSG believes that warnings need to be fairly concise, to avoid the risk of clients facing an increasing list of risk outcomes which experience has shown that they would tend to just click-through. The SMSG agrees that warnings must not be ambiguous and imprecise, but is nevertheless of the opinion that warnings should be allowed to be fairly generic. There are each year hundreds of thousands of new and different individual products with their own ISIN, so a granular analysis per product would be impossible in a fairly automated process.
27. P.38, para 71: Certain firms have policies and procedures which would imply that a client may not be allowed to proceed with a transaction after having received a warning (although such restriction may not follow from the rules in themselves). The SMSG advises to include in the GL that in such a case the firm should inform the client accordingly at an early stage, preferably before an appropriateness assessment is carried out, so that the client can make the decision not to continue with the assessment.

Q.11: Do you agree with the suggested approach on the qualifications of firm staff?

28. P.39, para 74: the SMSG in general welcomes the suggested approach regarding client-facing staff. However, with regard to non-client facing staff, the SMSG advises to amend the guideline as follows: *“Other staff that do not directly face clients but are involved in the appropriateness process in any other way should also possess the necessary skills, knowledge and experience depending on and proportionate to their particular role....”*,

Q.12: Do you agree with the suggested approach on record-keeping?

29. The SMSG has no specific comments regarding the guidelines concerning record-keeping. However, it advises to make reference to the EU data protection rules, by, for example, highlighting that in accordance with the GDPR, the customer should be able to request access to the data and results of the test.

Q.13: Do you see any specific difficulties attached to the requirement to keep records of any warnings issued and any corresponding transactions made by clients?

30. The SMSG has no comments in this respect.

Q.14: Do you agree with the suggested approach on determining situations where the appropriateness assessment is needed?

31. The SMSG believes that GL 12 is mixing up two different questions: one is the differentiation between advised and non-advised transactions, and the other is identifying when the service is an execution-only service and no appropriateness text is required. The SMSG advises to split these two entirely different questions into two separate guidelines.

It is, in this context, important to note that rules should be technology neutral, taking the specificities of execution only services into account. In an online environment with self-service tools and platforms, clients often log-on and trade without any personal contact with firm staff. As a consequence, such transactions should be considered as being provided at a client's own initiative, unless the client has been exposed to personalised marketing communications from the firm, e.g. by way of online or offline advertising.

32. P. 42, para.86. the SMSG would like to draw ESMA's attention on the communication clients receive from or on behalf of firms. The SMSG agrees that when communication is personalised, the firms should disqualify the resulting clients' transaction from the appropriateness test exception for "execution only" services. However, the increasing role of digital marketing and communications lead to a blurring of distinctions between generic and customised messages. The SMSG therefore advises to define in the guidelines what can be considered a personalised communication. Additionally, the SMSG advises to highlight in the guidelines how to distinguish a personalised communication from a personalised recommendation leading to a suitability test. For this purpose, the SMSG advises ESMA to reconsider and if necessary, update CESR (2010) Q&A on "Understanding the definition of advice under MIFID" .

Q.15: Do you agree with the suggested approach on controls?

33. The SMSG has no comments in this respect.

Q.16: When providing non-advised services, should a firm also assess the client's knowledge and experience with respect to the envisaged investment product's sustainability factors and risks? If so, how should such sustainability factors and risks be taken into account in the appropriateness assessment?

34. The SMSG fully recognises the importance of sustainable finance, but believes it is necessary to avoid the risk of 'overshooting', which could undermine the credibility of both the appropriateness test and sustainability goals. The purpose of the appropriateness assessment is to determine whether clients possess the required knowledge and experience to understand the risks they are assuming when investing in a particular product. It is important that this assessment focuses on the essential features and risks of products. Sustainability risks and factors do not necessarily stand out as more important than other factors and risks. Indeed, the SMSG is not aware of any evidence that ESG products exhibit risk/ reward profiles materially different from conventional products to such an extent that sustainability risks and factors should be incorporated in the appropriateness test.
35. In addition, ESG and sustainability are characteristics of financial instruments that should be assessed and reported to clients when portfolio management or investment advice services are provided. This means that extending the appropriateness test to the clients' knowledge and experience on these kinds of characteristics of financial instruments, would imply extending the scope of the current Level 1 rules. The implementation of ESG issues within the suitability tests and in the provision of portfolio management and investment advice is a challenging exercise for investment firms. The SMSG is of the opinion that it is not an "appropriate" moment to extend this to appropriateness assessment.

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

Adopted on 28 April 2021

[signed]

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[signed]

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