Brussels, 21 March 2022

EFAMA'S RESPONSE TO THE EUROPEAN COMMISSION'S TARGETED CONSULTATION ON OPTIONS TO ENHANCE THE SUITABILITY AND APPROPRIATENESS ASSESSMENTS

Introduction

EFAMA appreciates the opportunity to share our views on the European Commission's consultation on enhancements to the suitability and appropriateness assessments forming part of the wider, upcoming Retail Investment Strategy.

The suitability and appropriateness assessments are quintessential elements in how financial advice is provided to (retail) investors across the EU, balancing investor protection and the need of, in particular, retail investors to access financial advice in order to participate in the capital markets. Given their essential importance to the overall financial health of EU citizens, we believe that this consultation should sit at the end of a well-defined process. As these assessments are well-established over a number of years, the first step in their possible revision would be a thorough, objective and evidence-based stock-taking analysis, clearly identifying their strengths but also any potential weaknesses. Recommendations should be based on these outcomes and properly consulted with stakeholders. This is crucial, as the current consultation assumes weaknesses of the current system without specific evidence and proceeds to provide apparent solutions. Stakeholders must be given sufficient time (at least three months instead of four weeks) to reflect on these proposals in order to provide the European Commission with substantive, meaningful and helpful comments and feedback.

The importance of such a process is to guarantee that changes are not made for the sake of 'something new' but rather provide meaningful and tangible benefits for retail investors. Concrete benefits are paramount given that the regulatory requirements for suitability and appropriateness processes are in constant flux (with the ongoing ESMA consultation on the integration of sustainability considerations into the suitability process being a prime example), leading to sometimes incremental, but more often substantial changes for the investors and ongoing costs for the industry. We, therefore, are keen to ensure that the implementation costs triggered by these changes make a real difference to (retail) investors and result in an increase of retail participation in the capital markets – a goal strongly subscribed to by EFAMA.

Due to the short deadline for response of four weeks, we could not properly collect all members' feedback in line with our governance requirements and hence could not complete the online survey

in time. We, therefore, wish to submit our preliminary comments below.

In any case, due to the complexity of the issues at hand and the inherent follow-up questions (see below), **EFAMA and its members cannot provide any substantial assessments at this stage**. We can only ask the European Commission to carefully **consider our questions and continue the public engagement with stakeholders** to ensure a better understanding of the newly proposed concepts. This open dialogue should ensure that stakeholders, including EFAMA, can provide more meaningful feedback on the proposal's potential and impact soon. In the meantime, we stand ready to discuss any of our comments in further detail.

EFAMA's initial comments, observations and questions

As stated in our introduction, EFAMA strongly supports initiatives aimed at empowering investors and better enabling retail investors to make informed investment decisions, thus increasing their participation in the retail market.

We, therefore, understand the European Commission's desire for an investor-centric approach, taking into account a client's portfolio compared to a more specific product view. While this approach may not be beneficial in all instances (i.e. there are instances a product-specific approach may be more suitable), a portfolio view could ensure that, on a macro level, retail investors' overall risk-return profile is balanced through a well-diversified portfolio compared to these aspects needing to be covered by a single financial instrument/transaction. In frequent cases, the current framework's product-specific viewpoint can lead to clients' overall portfolios being too risk-averse (i.e a too low risk-return profile) in light of their overall investment objectives and (in many cases) their long-term investment horizons.

With this in mind, it is crucial to examine and analyse the consultation's proposal, break them down into its main elements and respond to each of them individually. In our understanding, the European Commission proposes (1) changes to the existing suitability and appropriateness assessments with a view to (2) creating a portable client's assessment which, in turn, would be translated into (3) a personalised asset allocation strategy (PAAS). This PAAS would be based on a standardised (yet to be developed) methodology of transforming a client's assessment/data into a high-level asset allocation proposal. The main driving force of these proposals is to make this assessment machine-readable and therefore portable, allowing retail investors more flexibility in their investments. This, however, also raises questions about the (4) financing of these portable assessments.

(1) Changes to the existing suitability and appropriateness assessments

The European Commission does not provide many details on the specific changes that are required to the existing suitability and appropriateness assessments. As the consultation justifiably focuses on retail investors (as it is part of the word on the wider Retail Investment Strategy), we nevertheless would advise the European Commission to take a holistic approach that can also be applied to sophisticated retail investors, professional investors and eligible counterparties.

Furthermore, the European Commission suggests that the "enhanced" suitability and appropriateness assessments could completely replace the current (more targeted product-specific). While we understand the benefits of a portfolio-centric view (as explained above), this may not the suitable for all situations, as investors may approach firms wanting to product-specific rather than portfolio solutions. Thus, both systems must coexist simultaneously and any PAAS solution (more on this below) should be seen as an additional service built on top of the suitability and appropriateness tests rather than no longer differentiating between various investment services, as suggested by the European Commission. This 'add on' approach should cater for innovation while, at the same time,

ensuring that it can be integrated into existing processes, thus safeguarding a favourable cost-benefit analysis.

(2) Creating a portable client's assessment

At first glance and in comparison to all subsequent elements, we see the most value in creating a standardised client's assessment (which would include objectives and needs, risk appetite, financial situation, knowledge and experience). This assessment could form the backbone of some sort of "retail investor passport", hopefully allowing the desired portability. Our experience shows that retail clients do not wish to fully complete various questionnaires firms are using for their advisory or portfolio management intake in an online environment. Indeed, this could facilitate clients' onboarding, allowing retail investors more flexibility and thus providing them with increased investment opportunities.

This being said, essential elements of such a portable client assessment need to be further explained and answered before we can provide more concrete feedback:

- Given that the data of those client's assessments must be standardised to a certain degree to allow portability, how can we ensure that firms are still allowed to ask additional questions or request additional information (which may not be part of the standardised process), thus stifling innovation? A middle way must be found to ensure that firms are still allowed to request more information whether or not that specific data is portable (i.e. part of the retail investor passport) or not.

- Many important liability questions arise: What are the potential liability risks for the firm performing the initial assessment? Who is responsible for the update of the assessment (for example in cases where the client has only performed a client's assessment but does not have any investments with the firm)? Can subsequent investment firms rely on the retail investor passport or would it need to repeat the suitability and appropriateness assessments to ensure its own due diligence thereby diminishing the portability benefits?

- Under which circumstances does the assessment need to be updated? We understand that MiFID II already requires updates after a certain time (i.e. at least yearly) or in case of relevant change of circumstances (life events, external circumstances, etc.). However, how does this interlink with the portability of the assessment and multiple investment firms (which is also linked to the liability questions raised above)? Can a subsequent firm simply ask whether a client the information in the retail investor passport is still up-to-date and trust this assessment?

- How will this assessment be financed given its portability? Please see more considerations around the financing below.

- Who owns the data? We assume that the client would have full ownership of his/her data. However, multiple questions arise concerning data ownership, the privacy of data and data processing (i.e. GDPR). We understand that this issue will also feature in the context of the European Commission's Open Finance framework. However, a consultation is only scheduled for Q3 of this year, leaving many questions open until then.

Many of the above questions are crucial in determining whether subsequent firms would have to reassess either parts or the whole of the assessment to ensure that it fulfils its own duties and responsibilities. Detailed answers to these questions determine whether such a portable client assessment could work in practice.

(3) Standardising or Personalising an Asset Allocation Strategy

If we understand correctly, as a next step, a firm then takes the (standardised) client's assessment to create a Personalised Asset Allocation Strategy (PAAS). This assessment is meant to be standardised (i.e. there is an underlying methodology that translates the client data into specific asset allocation proposals) meaning that we can expect the same outcome no matter which investment firm provides a PAAS. We struggle with this concept for several important reasons.

First and foremost, no standardised methodology exists for translating a client's assessment into an asset allocation. Currently, these recommendations are based on the firm's unique know-how, expertise and locality. Different recommendations and investment approaches can be explained (but not limited to) by differences in the firm's size, location, client base and the range and type of financial instruments on offer. This heterogeneity is crucial and we see it fundamental that investment firms can continue to provide their own, specialised and personalised recommendation to clients.

With this in mind, we should not strive towards such standardisation, as it clearly entails too many downside risks for retail investors:

- First, standardising asset allocations would be a massive undertaking that may lead to a very complex methodology.

- Second, such a standardised asset allocation would need to be accepted by all other investment firms. It must be ensured that its acceptance does not trigger due diligence liability concerns which may force other investment firms to simply repeat the process. (Please see our questions around liability in our comments above.)

- Third, the more personalised the asset allocation is, the harder it will be to replicate it by another investment firm. Let us provide an example: To achieve a certain risk-return profile, investment firm A decides to allocate 100% of an investor's portfolio in EU blue chips. Investment firm B may decide to achieve the same risk-return profile with 10% government bonds and 80% blue chips and 10% alternative investments. Does firm B follow firm A's PAAS even though they both try to achieve the same risk-return profile? This example only covers the highest level of asset classes, but the more detailed types of sub-asset classes are required, the harder this will be to also replicate the PAAS for the same reasons as stated above. There may be a possibility to standardise a client's risk-return profile at a very high-level (akin to the synthetic risk-return profile, SRRI, for UCITS or the Summary Risk Indicator for PRIIPs). However, questions remain if the complex methodology for translation is justified and whether such a high-level risk-return profile would provide tangible benefits for investors.

- Last but certainly not least, this translation of client assessments into asset allocations (if even possible) will hinder competition and reduce choice for retail clients, as the goal of such standardisation is that a certain type of retail investor will receive the same asset allocation. This could lead to a dangerous precedent of "group think" leading to a situation where one type of investor is automatically being channelled into the same asset allocation. Such a situation could even raise serious financial stability concerns.

(4) Financing

Another important element that has not directly been raised by the European Commission in its current consultation is how the client assessment and/or PAAS, due to their inherent portability, are supposed to be financed by retail investors. We note that the Commission is asking (in Question 5) whether the PAAS should only be performed by independent advisers or not. In line with EFAMA's previous argument around a potential ban of retrocessions, we strongly caution that the client

assessment/PAAS could only be performed by an independent adviser as this could make it harder for retail investors to access advice, creating an advice gap.

As the European Commission intends to make the client assessment and PAAS portable, we would like to better understand the business case for an investment firm to provide a client assessment and/or PAAS. If an investor can have one investment firm provide the assessments, but can then immediately go to another investment firm to implement this asset allocation strategy, then the first investment firm must charge for the assessments upfront. Thus, de-facto banning the financing of investment advice through retrocessions, which is (in terms of invested assets) beneficial for retail investors with small amounts of money to invest.

In line with our above comments (whether the PAAS is meant to replace the existing suitability and appropriateness tests), there is a risk that if the PAAS is the only way for investors going forward that they may not be able to invest unless they have a PAAS at hand. Combined with the outstanding financing issue, this could lead to a situation that makes it harder, not easier for retail investors to invest.

ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 28 member associations, 58 corporate members and 24 associate members. At end Q1 2021, total net assets of European investment funds reached EUR 19.6 trillion. These assets were managed by more than 34,600 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,600 AIFs (Alternative Investment Funds). At the end of 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 27 trillion.

More information is available at www.efama.org

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