European Fund and Asset Management Association

EFAMA's comments on ESMA's Consultation Paper Guidelines on certain aspects of the MiFID II suitability requirements [ESMA35-43-748]

General Comments

EFAMA[1] welcomes provision by ESMA of guidelines on certain aspects of the MiFID II suitability requirements. In many areas, we agree with the proposed approach but we have key concerns that will need to be addressed by ESMA in its final guidelines.

The requirements for traditional advice (i.e. with human intervention), automated advice and portfolio management should provide the **same level of investor protection**, even if the implementation of a particular rule needs to be adapted to reflect the different delivery media and, for portfolio management, the very different nature of the service. It should not be the case that requirements for the latter two are more stringent than those for traditional advice, or vice versa. Also, any requirements need to be operationally workable.

The **draft guidelines focus too much on retail clients** and do not account for the significant differences between investment advice and discretionary portfolio management services. It is essential that the obligations are also proportionate for individual portfolio management provided to professional clients.

This is most apparent in ESMA's approach to **"switching investments"** (Guideline 10) which would give rise to major operational issues and costs when discretionary portfolio management is provided to professional clients. The suggested approach **is neither proportionate nor necessary** and carries the risk of fundamentally undermining an investment firm's ability to carry out its services to its client.

Q1: Do you agree with the suggested approach on the information to be provided on the suitability assessment and specifically with the new supporting guidelines on robo-advice? Please also state the reasons for your answer.

We generally agree with ESMA's balanced approach on how investment firms inform their clients about the suitability assessment.

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 14.1 trillion managed by 58,400 investment funds at end 2016. Just over 30,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 27,800 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org

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However, some of the proposed rules on automated advice tools may hinder their future development, potentially depriving investors of alternative access to investments if they are not correctly calibrated.

There is a greater uptake in the use of digital means to interact with investors, but online questionnaires and direct banking are by no means a new phenomenon. The development of automated advice is of benefit to consumers. It can provide investment solutions for groups of customers with lower investment volumes, allowing them to access investment opportunities that traditionally have been available only to clients with much greater investment capital. Also, automated advice can be a valuable alternative for consumers who, for whatever reason, are apprehensive to consult a financial advisor.

In times of persistent low interest rates and a need for the EU economy to move away from bank dominated funding to a more balanced funding model, digital media offer an easy way for consumers to convert cash savings into investments[2].

With this in mind, we believe that ESMA should not stifle these potential benefits by directly or effectively imposing more onerous rules for an investment service which is quite similar, though provided through digital means. This position is also shared by European Parliament's Economic and Monetary Affairs Committee which noted that "the same consumer protection requirements should apply to robo-advice as to face-to-face advice"[3].

In relation to ESMA's draft guideline we highlight in particular that:

- ESMA should carefully consider the overall amount of information provided to investors. MiFID II will already significantly increase the amount of information provided to clients. Yet further disclosures for robo-advice may actually have an adverse effect, leading to "information overload". ESMA should thoroughly analyse whether any additional information requirement will really be to the benefit of the investor or will not be noticed in the large amount of information to be provided under MiFID II.

- MiFID II already imposes a requirement for all firms to explain the nature of the service they offer. Under that requirement, providers of digital services will describe whether the service is solely digital or includes any element of human intervention, optional or not. We do not understand the need for additional requirements as part of the suitability requirements.

- In neither a digital or face-to-face situation will the customer be in the position clearly to assess what the advice is based on and potentially evaluate any algorithms used. It will therefore be the responsibility of NCAs and ESAs to properly evaluate the soundness of these tools.

In the light of these comments, we urge that the relevant supporting guidelines (paras. 20 to 22) be fundamentally reviewed.

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[2] For further comments, please also see EFAMA's response to European Commission's Consultation on FinTech: http://www.efama.org/Publications/Public/EFAMA_response_EC_consultation_FinTech.pdf

[3] European Parliament resolution of 17 May 2017 on FinTech: the influence of technology on the future of the financial sector (2016/2243(INI)); para. 29

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? Please also state the reasons for your answer.

The guidelines should distinguish more clearly between retail and professional clients. Suitability represents a key risk for retail clients, but for professional clients this risk is lower as these clients are likely to have the necessary level of experience and knowledge and greater ability to bear losses. Furthermore, the use of bespoke mandates is very common and needs to be properly and appropriately reflected in the guidelines. In particular, we noted that the guidelines currently do not reflect the caveat for certain professional clients and certain investment services under Article 54(3) of the MiFID II Delegated Regulation.

Again, we do not understand the need for additional rules regarding robo-advice models (please also see our response to Q1). This is most apparent in supporting guideline (para. 30), which provides hardly any additional investor protection in relation to the wider suitability guidelines. For example:

- It is undisputed that investment firms have to analyse collected information to "conclude that the advice provided is suitable" (para. 30, first bullet point). This must be done whether or not the client accesses the questionnaire online or through a human advisor. It is not necessary to restate this in the context of robo-advice.
- In relation to the 3rd bullet point on human interaction, it is in the firm's own interest to provide tools where the clients can pose any questions. If they do not and the client has questions, there is a high change that the client will simply walk away from the questionnaire and not continue his/her choice to invest through that digital service.

We therefore ask ESMA to review supporting guideline para. 30 and to delete unnecessary elements.

Q3: Do you believe that further guidance is needed to clarify how firms should assess clients' ability to bear losses?

The current guidance is too focused on retail clients. It does not take into consideration that in the professional market (including large institutional client such as pension schemes, insurance companies, other corporates, sovereign wealth funds etc.), investment managers may not be able to assess a client's overall ability to bear losses, as a firm may be managing only a part of the client's portfolio. It can assess the ability to bear losses only at the mandate level rather than at the client level. A transaction can bear potential loss but at the same time reduce the overall risk profile of the client. We ask that this be specifically acknowledged in the final guidelines.

In addition, our comments above on Article 54(3) of the MiFID II Delegated Regulation are relevant to this Question.

Q4: Do you agree with how the guideline on the topic of 'reliability of client information' has been updated to take into account behavioural finance and the development of robo-advice models? Please also state the reasons for your answer.

We acknowledge the importance of learning lessons from behavioural finance and that it is important to have reliable and consistent analysis. However, we believe that in a number of areas additional guidelines for the robo-advice space are not needed. The guidelines should ensure the same (high) investor protection standards for the provision of advice, however delivered. Too onerous additional requirements (above and beyond the ones for human-provided advice) may jeopardise the development of robo-advice models.

Again, we note that the guidelines are focused on retail clients, which is reinforced by the updates made to take into account lessons from behavioural finance and the requirements to individualise questions for the client. Professional clients are more experienced and investment firms should be able to continue to place more reliance on the accuracy and consistency of the information provided.

We do not agree with ESMA's approach to complex products (supporting para. 34), which requires a client to "*understand the mechanisms which make the investment product 'complex'*". We agree that it is imperative for a client to understand a product's overall risk/return profile (in particular for complex products), but this does not extend to the requirement that a client must understand the individual (i.e. underlying) elements of such a product (i.e. their mechanism of functioning).

We strongly suggest clarifications be made to supporting guideline para. 34.

Last but not least, we appreciate that an advisor or portfolio manager should understand the client's knowledge and comprehension of risks and natures of financial instruments, but we question that the test ESMA indicates in the new supporting guideline para. 44(a) is reasonable. A client who is seeking investment advice does not intend to pass a test but wishes to benefit from the advisor's competence. Practical examples could be useful to show a client the typical performance situations, which ESMA already indicates in guideline 45.

We therefore suggest the deletion of supporting guideline para. 44.

Q5: Do you agree with the suggested approach on the topic of 'updating client information'? Please also state the reasons for your answer.

We agree with the suggested approach.

Q6: Do you agree with the suggested approach to conduct the suitability assessment for a group of clients, especially where no legal representative is foreseen under applicable national laws? Please also state the reasons for your answer.

While we agree in principle with the suggested approach for retail clients, the need for regulatory guidance on the topic is less needed for professional clients.

We note the introduction of a requirement for an investment firm to inform clients *ex ante* about its policy. Article 54(6) of the MiFID II Delegated Regulation requires an investment firm to establish and implement a policy and to record this policy, but there is no requirement to disclose such policy to clients. We agree with the principle of providing relevant information, but the guidelines should not introduce an additional disclosure requirement not specified in the Directive.

General guideline 6 (para. 56) should therefore be amended accordingly.

Q7: Do you agree with the suggested approach on to the arrangements necessary to understand investment products for the purposes of suitability assessment? Please also state the reasons for your answer.

We generally agree with the suggested approach, but we again caution ESMA against imposing too many formalised information requirements such as the new requirement to inform the client about an updated profile. If the client informs the firm about changes in his/her personal circumstances that are relevant for his/her profile, it is already clear that the firm will have to change the client's profile accordingly.

Q8: Do you agree with the additional guidance provided with regard to the arrangements necessary to ensure the suitability of an investment? Please also state the reasons for your answer.

The draft guidelines are in contradiction with other parts of ESMA's draft guidelines with respect to the treatment of portfolio management. In particular, para. 81 (p. 59) undermines the portfolio management approach, as the current draft states that "knowledge and experience of the client should be assessed regarding **<u>each investment product and risks</u>** involved in the related transaction" [emphasis added by EFAMA]. In relation to portfolio management an investment firm does not have to assess each single investment product and the risks involved against the knowledge and experience of the client.

This approach does not differentiate between investment advice and portfolio management, where the investment decisions are taken by the investment firm and not the client. It is also in contradiction with para. 36(b) of ESMA's own draft guidelines which – correctly – state that "when portfolio management is to be provided, as investment decisions are to be made by the firm on behalf of the client, *the level of knowledge and experience needed by the client 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 advice 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. Firms should gain a very clear understanding and knowledge of the investment profile of the client" [emphases added by EFAMA].

<u>Having to assess each transaction at the level of the transaction instead of at the level of the portfolio as a whole undermines and contradicts the specificities discretionary portfolio management while depriving investors of the benefits of diversification.</u>

Under a portfolio management service, the client <u>delegates the decision on the purchase of the individual instrument to a professional</u>. The portfolio manager is entrusted to build up a diversified portfolio with the intention of reducing unsystematic risk in a way the investor would not be able to do it him/herself. An approach as suggested by ESMA would not reflect the best interests of investors seeking a diversified portfolio of investments. Whereas for the provision of investment advice each and every instrument has to be suitable, portfolio management allows investors access to a diversified portfolio build up by a professional. A portfolio manager should not be limited to selecting from only a limited range of individually low-risk investment options, such as government bonds. This will often result in a portfolio that does not overall meet the client's objectives or needs.

Furthermore, such an approach is in direct contradiction with ESMA's Guidelines on "MiFID II product governance requirements", in particular paras. 52f on "portfolio management, portfolio approach, hedging and diversification". ESMA requires reporting at the product level only where the client falls within the negative target market of a specific product (see para. 55). For all other cases, no reporting at individual product level is required, even if a product does not match the knowledge and experience requirements of the client. The portfolio approach for the suitability test should be the same. It should state that the knowledge and experience and the risks involved in a particular transaction should not be assessed on the product level but at the level of the portfolio.

We urge ESMA to amend the guidelines to state that transactions that are compliant with the overall investment strategy do not require any additional suitability assessments.

Furthermore, we note that ESMA introduces "concentration risk" as part of a wider credit risk assessment in supporting guidelines para. 84. While the concentration of credit risk may very well be considered when providing portfolio management services, ESMA again assumes that an investment firm has full knowledge of a client's entire portfolio. As this is often not the case and because such a notion cannot be found in either the Level-1 or Level-2 texts, **we urge ESMA to delete the reference to "concentration risk" from para. 84.**

Last but certainly not least, we generally agree with the proposal that firms should base their assessment on information available to them (i.e. as an investment firm). However, we would point out that even within a firm, the sharing of information might be prohibited or restricted (e.g. due to data protection rules). Moreover, depending on the product and the amount to be invested, a full assessment of the client's portfolio might not be necessary (e.g. for smaller investments in mass retail products).

Again, in relation to digital media, firms are already required under MiFID to ensure that their staff is properly trained and competent. Clearly, digital tools should be fit for purpose and produce appropriate results. However, digital media should not be required to provide for a higher level of suitability assessment than other (human) delivery mechanisms, as indicated in supporting guideline para. 78. **This supporting guideline should be deleted**.

Q9: Do you agree with the suggested approach for ensuring that firms assess, while taking into account costs and complexity, whether equivalent products can meet their clients' profile? Please also state the reasons for your answers.

We understand the intent of the guidelines but there are instances where this requirement does not seem relevant and would simply not be beneficial to the client and/or the investment firm. For example, in the case of discretionary portfolio management activities where the investment firm exercises its discretion within the limits of the client's agreed guidelines. In such instances, it is unclear what benefit such an exercise would have for the client. In addition, it can be expected that the client would not be interested in alternative solutions.

In particular, Guideline 9 (para. 87) makes the general assumption that access to less expensive and less complex products is always possible. This assumption forgets that access to financial instruments is also very much dependent on the type of investment service being offered. For example, due to distributors being remunerated differently, independent advice may offer a different set and/or scope of financial instruments than non-independent advice. This must be taken into account by ESMA's guideline. **Guideline 9 should therefore be amended to take into consideration the type of service being provided to the client (i.e. independent advice, non-independent advice and portfolio management).**

Q10: Do you agree with the suggested approach for conducting a cost-benefit analysis of switching investments in the context of portfolio management or investment advice? Please also state the reasons for your answer.

"Switching" in relation to portfolio management

As stated in other parts of our response, we again can see the value of this approach only in a retail context where a client holds a small number of securities in a portfolio and these additional safeguards are put in place to ensure that "switching" does not occur for the benefit of the investment firm.

We appreciate ESMA's thoughts around common portfolio strategies (as set out in para. 96), but its approach for bespoke mandates and investment strategies in para. 97 does not reflect the reality of portfolio management, in particular for professional clients, and does not give sufficient consideration to its fiduciary nature and the fact that the portfolio manager is applying the investment strategy as instructed, in such cases, by the client. To illustrate our point, we highlight the following real-world implications:

- A mandate from a client might include both part of a portfolio management service and receipt and transmissions of orders (i.e. investment firm might receive instructions from clients to execute buy/sell trades in relation to its overall portfolio). A professional client or eligible counterparty might instruct a switch, for example, to express an investment preference at a particular time or for other reasons (such as compliance with the overall investment policies).
- The same principle applies for many discretionary portfolios that are sub-advised or delegated mandates linked to a fund where inflows or outflows initiated by the client occur on a daily basis requiring the asset manager to trade to reflect the direction of monetary flow.
- Switching investments may also result from the need to address compliance with the client's investment guidelines applicable to the mandate. For example,
    - In the context of a passive strategy linked to particular index, the portfolio manager would normally be expected to rebalance the portfolio from time to time (making any necessary purchases and sales of assets) as the constituents of the underlying index change. Rather than a result of a cost-benefit decision, the switch follows the investment objective of the mandate.
    - When the portfolio manager rolls forward a derivative contracts, as the existing derivative contract is to be closed out and a new one opened for the same underlying asset.
    - Where a bond portfolio manager needs continuously to adjust a yield curve or duration in order to ensure the best outcome for its client.
- In relation to managing a segregated mandate an investment firm may, or may not, be the only portfolio manager. Continually to carry out checks to ensure the analysis is done against

all the client's existing investments, as the guidance implies, would add a further layer of administration that would be impossible to undertake at no additional cost for clients. Regardless of whether there are other portfolio managers, the portfolio manager is managing to a precisely defined mandate agreed with, indeed often given to them by, the client. To gain the wider knowledge of their investments would require the firm to go beyond what the client had decided to disclose. Further to the previous point, a client with mandates with different managers is unlikely to receive real time position information, and even if it did, it would likely be unwilling and possibly unable to share that information with another investment firm.

- From an <u>operational standpoint</u>, such trade-by-trade documentation evidencing of each trade's cost-benefit analysis would add a significant and unnecessary burden not only on an investment firm's ability to execute its mandate in an efficient manner (counter to its best-execution obligation) but would add incremental costs for each trade, thus unnecessarily reducing a client's overall investment returns.

As the mandate of portfolio management is inherently different from investment advice, we urge ESMA to make sufficient distinction between these two investment services in its final guidelines. In particular, due to the fiduciary nature of the latter, ESMA must acknowledge that the client expects the portfolio manager to exercise full discretion in buying and selling instruments for its portfolio, which are made in accordance with the investment objective and other pre-agreed parameters. Thus, if a transaction does not change the pre-agreed investment profile, and as long as the switching is consistent with portfolio strategy, the assessment should not be required for each single transaction.

ESMA should make clear a cost and benefit analysis can be performed beforehand on a theoretical basis when the mandate is negotiated.

<u>Cleared definition of "switching"</u>

In addition to the point on proportionality, we ask for greater clarity on what would be regarded as a switch, as opposed to two separate investment or advice decisions to ensure consistency. It is unclear what extent two trades would be regarded as a switch or how situations such as rebalancing to index weights or rolling over derivatives would be considered. As the guidelines introduce a requirement for investment firms to monitor the risk of circumventing the obligation to assess costs and benefits of recommended switch, guidance is needed for investment firms to build their processes and controls.

<u>"Switching" and a client's existing investments</u>

Delegated Regulation's Article 54(11) requires investment firms to "collect the necessary information on the client's existing investments and the recommended new investments".

It is clear from the proposed Guideline 3 that before providing portfolio management services, firms need to collect all "necessary information" about the client's financial situation. The extent of "necessary" information will vary, taking into account the features of the portfolio management services to be provided and the characteristics of the clients. The principle of proportionality in MiFID allows firms to collect the level of information proportionate to the service they offer. Guideline 3 goes on to state that firms are expected to possess information about the client's financial investments held at ***this*** firm on an instrument-by-instrument basis.

Given this, and the way in which the article relates the client's "existing investments" to the "new investments", it is clear that the phrase "existing investment" refers to the investment product that exists in the client's portfolio, which is to be sold. The scope of information to be collected, under Article 54(11) relates only to the investments that are to form part of the "switch".

ESMA should make clear that, especially for professional clients, this phrase does *not* refer to investments held by the client outside its portfolio managed by the investment firm.

Q11: Do you believe that further guidance would be needed with regard to the skills, knowledge and expertise that should be possessed by staff not directly facing clients, but still involved in other aspects of the suitability assessment? Please also state the reasons for your answer.

We do not believe that further guidance is needed at this time with regard to the skills, knowledge and expertise that should be possessed by staff not directly facing clients, but still involved in other aspects of the suitability assessment. ESMA has already provided thorough guidance through the guidelines on knowledge and competence of personnel providing advice. Furthermore, we believe that the guidelines regarding competence of staff for automated tools are superfluous because of the general requirement to ensure compliance with the obligations under MiFID II's Article 16 para. 2.

Q12: Do you have any further comment or input on the draft guidelines?

Again, **we urge ESMA to adopt a balanced approach for portfolio management services provided to professional clients**, both for delegated portfolio management for collective investment funds and for individual mandates. Professional clients usually have a very specific understanding of the investment strategy the asset manager should apply.

Regarding supporting guidelines paras. 37, 38 and 40, ESMA should bear in mind that automated advice tools have limited options to gather information in a tailored way. Furthermore, even in the case of human advice, there are limits to individualising the process of information gathering because the firm must ensure that it provides advice in a consistent manner. Consequently, for mass-retail products, it should be clear that the information-gathering process can be appropriately less detailed and less tailored.

Last, but no less importantly, the requirement in supporting guideline para. 105 to record every investment decision is both disproportionate and unjustified. There is no such requirement in either the Level-1 or Level-2 texts. Also, the guideline presumes that all elements of the end-to-end investment service are performed by the same firm, which is not always the case. For example, Firm A may provide investment advice to its customer in relation to specific transaction, but the customer uses Firm B to execute the transaction

Q13: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

No response.

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