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Regulatory Newsflash

ESMA Consultation Paper on certain aspects of the MiFID II suitability requirements

Introduction

On July 13, the European Securities and Markets Authority (hereafter "ESMA") published a consultation paper containing draft guidelines on certain aspects of the MiFID II suitability requirements. Comments to the consultation paper must be submitted to ESMA by 13 October 2017. ESMA expects to publish a final report, and final guidelines, in Q1/Q2 2018.

This newsletter provides an overview of some of the draft guidelines and their main characteristics.

Information to clients about the purpose of the suitability assessment

The aim of informing clients about the purpose of the suitability assessment is to encourage them to provide up-to-date, accurate and complete information so that the firm can assess whether products are suitable for him. Clients should, for example, be informed that they may receive questions regarding investment risk and return and what the purpose of answering those questions is. The way in which this information must be provided to the client is not determined, however, the format used should enable posteriori controls to check if the information was provided.

Such information should also include a clear statement that it is the firm’s responsibility to conduct the suitability assessment and no disclaimer or statement can limit their responsibility.

ESMA also proposes new supporting guidelines on information to clients about the purpose of the suitability assessment in the context of robo-advice. In order to ensure that firms provide clients with comprehensive information to allow them to understand the purpose of such tools, this information should include statements or explanations of:

- the use of an algorithm;
- the degree of human involvement in the process;
- how the information gathered will be used;
- how and when the client’s status will be updated.

Firms providing robo–advice should also consider whether their written disclosures are designed to be effective. E.g. is relevant information sufficiently emphasised (e.g. through the use of pop-up boxes); should some information be accompanied by interactive texts (e.g. tooltips) or are other means to provide additional details required; is the presentation and formatting of information adapted to the mobile platforms used for the robo–advice.

Know your client and know your product

Arrangements necessary to understand clients

Firms must establish, implement and maintain adequate policies and procedures (incl. appropriate tools) to enable them to collect and assess all information necessary to conduct a suitability assessment for each client in a consistent way irrespective of the means used.
When collecting information for the purpose of a suitability assessment through a questionnaire or by other means, firms should:

- give attention to the clarity, exhaustiveness and comprehensibility of the questionnaire, avoiding misleading, confusing, imprecise and excessively technical language;
- avoid presenting questions in batteries (collecting information on a series of items through a single question);
- avoid orienting investors’ choices (due to lay out);
- avoid allowing the reply “no answer” too often.

The information should include different elements that may affect, for example, the analysis of the client’s financial situation (including his ability to bear losses) or investment objectives (including his risk tolerance). ESMA provides insights on how, e.g. the client’s marital status, family situation, age, etc., may have an impact hereon.

When determining what information is necessary, firms should keep in mind the impact that any significant change regarding that information could have concerning the suitability assessment.

Regarding knowledge and experience, ESMA states that:

- it should be considered altogether for the overall appraisal of the client's understanding of the products and risks involved;
- firms need to sufficiently assess the understanding by the client of the main characteristics and the risks related to the product types in their offer;
- mechanisms need to be adopted to avoid self-assessment and ensure the consistency of the answers provided by the client;
- firms should appraise the client's financial literacy and understanding of basic notions such as, for example, investment risk and risk-return trade off.

Firms providing robo-advice should design an online questionnaire able to gather sufficient information to support the assessment of suitability. Several factors should be taken into account, such as:

- whether the information collected through the online questionnaire allows the firm to conclude that the advice provided is suitable for its clients on the basis of their knowledge and experience, their financial situation and their investment objectives and needs;
- whether the questions are sufficiently clear and/or additional clarification or examples to clients are provided when necessary;
- whether some human interaction is available to clients when responding to the online questionnaire;
- whether steps have been taken to address inconsistent client responses.

Extent of information to be collected from clients (proportionality)

ESMA clarifies that the principle of proportionality in MiFID allows firms to collect the level of information proportionate to the products and services they offer, but that it does not allow firms to lower the level of protection due to clients.

To determine the extent of the information to be collected, firms should consider:

- the type of the financial instrument or transaction that the firm may recommend or enter into, i.e. the complexity, liquidity and level of risk;
- the nature and extent of the service that the firm may provide, i.e. investment advice (detailed knowledge and experience) versus portfolio management (general knowledge and experience);
- the nature (vulnerability, (in)experience, (non)professional), needs (investment objectives and horizon) and circumstances (financial investment investments) of the client.

Reliability of client information

Clients are expected to provide correct, up-to-date and complete information necessary for the suitability assessment. However, firms need to take reasonable steps to check the reliability, accuracy and consistency of information collected about clients. Firms cannot limit their responsibility by means of a specific clause in the contract with the client, in the general terms and conditions, or otherwise.

Self-assessment should be counterbalanced by objective criteria. For example, instead of asking whether the clients believe they have sufficient funds to invest, the firm could ask for factual information about the client's financial situation.

Where firms rely on tools as part of the suitability process (e.g. on-line questionnaires or risk-profiling software), they should ensure that they have appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results. Firms should also take reasonable steps to mitigate potential risks associated with the use of such tools.

In order to ensure the consistency of client information, firms should view the information collected as a whole, be alert to any relevant contradictions between different pieces of information collected, and contact the client in order to resolve any material potential inconsistencies or inaccuracies.

Firms should adopt mechanisms to address the risk that clients may tend to overestimate their knowledge and experience. Such measures are particularly important in the case of robo-advice, since the risk of overestimation by clients may result higher when they provide information through an automated (or semi-automated) system.

Updating client information

Firms should regularly review client information to ensure that it does not become manifestly out of date, inaccurate or incomplete. To this end, firms should implement procedures to encourage clients to update the information originally provided where significant changes occur.

Frequency of update might vary depending on, for example, clients' risk profiles and taking into account the type of financial instrument recommended. Certain events might also trigger an updating process, for example, for clients reaching the age of retirement.

ESMA finds it important to adopt measures to mitigate the risk of inducing the client to update his own profile so as to make appear as suitable a certain investment product that would otherwise be unsuitable for him, without there being a real modification in the client's situation, and provides insights on good practices.

The client always needs to be informed when the additional information provided results in a change of his profile.

Arrangements necessary to understand investment products

Firms must ensure they understand the characteristics, nature and features of the investment products they are recommending or investing into on behalf of their clients.

To this end, firms must:

- adopt robust and objective procedures, methodologies and tools that allow them to appropriately and individually consider the different characteristics and relevant risk factors of investment products and classify them correctly;
- assess how certain products could 'react' under certain circumstances;
- assess the level of 'complexity' of products, which should be matched with the characteristics or profile attributed to the client (the more complex a product, the more detailed the information with

regard to the knowledge, experience, financial situation and investment objectives);
- ensure that the information used to understand and correctly classify investment products included in their product offer is reliable, accurate, consistent and up-to-date;
- review the information used so as to be able to reflect any relevant changes that may impact the product's classification;
- the elements used for the classification of products for the purposes of suitability assessment should be consistent with those used for the purposes of the identification and assessment of the target market in accordance with requirements on product governance.

Matching clients with suitable products

Arrangements necessary to ensure the suitability of an investment
ESMA reminds firms that the suitability assessment is not limited to recommendations to buy a financial instrument. Every recommendation must be suitable, whether it is, for example, a recommendation to buy, hold or sell an instrument, or not to do so.

A firm should establish policies and procedures which enable it to ensure inter alia that:
- the services provided to the client take account of an appropriate degree of risk diversification;
- the client has an adequate understanding of the relationship between risk and return;
- the financial situation of the client can finance the investments and the client can bear any possible losses resulting from the investments;
- any personal recommendation or transaction entered into in the course of providing a service, where an illiquid product is involved, takes into account the length of time for which the client is prepared to hold the investment; and
- any conflicts of interest are prevented from adversely affecting the quality of the suitability assessment.

When a firm conducts a suitability assessment based on the consideration of the client's portfolio as a whole, this means that, on the one hand, the knowledge and experience of the client should be assessed regarding each investment product and risks involved in the related transaction; on the other hand, with regard to the client's financial situation and investment objectives, the suitability assessment about the impact of the product and transaction can be done at the level of the client's portfolio.

When advising on the whole portfolio of the client or when providing portfolio management, firms should ensure an appropriate degree of diversification within the client's portfolio, taking into account the client's portfolio exposure to the different financial risks, especially credit risk. In cases where the size of a client's portfolio is too small to allow for an effective diversification in terms of credit risk, the firm should consider directing those clients towards types of investments that are 'secured' or per se diversified.

Firms that rely on tools in the suitability assessment process (such as model portfolios, asset allocation software or a risk-profiling tool for potential investments), should:

- ave appropriate systems and controls to ensure that the tools are fit for purpose and produce satisfactory results;
- ensure that the tools are designed so that they take account of all the relevant specificities of each client or investment product;
- regularly monitor and test the algorithms that underpin the suitability of the transactions recommended or undertaken on behalf of clients. ESMA sets forth further guidelines to take into account when defining such algorithms.

Firms providing robo-advice should also adopt and implement policies and procedures that address issues (at least) related to the following:
- the questionnaire eliciting sufficient information to allow the firm to conclude that the advice provided is suitable for the client;
- the prevention and detection of, and response to, cybersecurity threats;
- the protection of client accounts;
- the use of social and other forms of electronic media in connection with the marketing of the robo-advice services provided.

Costs and complexity of equivalent products
Firms should have a process in place to assess products available that are broadly 'equivalent' to each other in terms of ability to meet the client's needs and circumstances, such as financial instruments with similar target markets and similar risk-return profile.

When considering the cost factor, firms should take into account all costs and charges covered by MiFID II. As for the complexity, firms should refer to the criteria identified above (see the arrangements necessary to understand investment products).

For firms with a restricted range of products, or those recommending one type of product, it is important that clients are made fully aware of such circumstances. It is particularly important that clients are provided appropriate information on how restricted the range of products offered is.

Where a firm uses common portfolio strategies or model investment propositions that apply to different clients with the same investment profile, the assessment of cost and complexity for 'equivalent' products could be done on a higher level, centrally, although a firm will still need to ensure that the selected investment products are suitable and meet their clients' profile on a client-by-client basis.

Firms should be able to justify those situations where a more costly or complex product is recommended over an equivalent product, taking into account that for the selection process of products in the context of investment advice or portfolio management further criteria can also be considered. When providing investment advice, a clear explanation of the reasons for recommending a more costly or complex product should be included in the suitability report.

Costs and benefits of switching investments
Firms should take all necessary information into account, so as to be able to conduct a cost-benefit analysis of the switch, i.e. an assessment of the advantages and disadvantages of the new investment(s) considered. When considering the cost dimension, firms should take into account all costs and charges covered by MiFID II.

When providing investment advice, a clear explanation of the reasons why the benefits of the recommended switch are greater than its costs should be included in the suitability report.

Firms should also adopt systems and controls to monitor the risk of circumventing the obligation to assess costs and benefits of recommended switch, for example in situations where an advice to sell a product is followed by an advice to buy another product at a later stage (e.g. days later), but the two transactions were in fact strictly related from the beginning.

Other related requirements

Qualifications of firm staff

Staff (client facing or otherwise involved in the suitability process) must:
- understand the role they play in the suitability assessment process;
- possess the skills, knowledge and expertise necessary, including sufficient knowledge of the relevant regulatory requirements and procedures, to discharge their responsibilities.

Record-keeping
Record-keeping arrangements adopted by firms must be designed to enable firms to track ex-post why an investment was made. This could be important in the event of a dispute between a client and the firm, but it is also important for control purposes.

Therefore, a firm is required to record all relevant information about the suitability assessment, such as information about the client and information about financial instruments recommended to the client or purchased on the client’s behalf, as well as the suitability report provided to clients. Those records should include:
- any changes made by the firm regarding the suitability assessment, in particular any change to the client’s investment risk profile;
- the types of financial instruments that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them.

Firms should have in place policies and procedures that could appropriately ensure the business continuity, the backup and the functioning of disaster recovery plans covering any systems that support the delivery of digital advice to clients.

Firms should understand the additional risks that could affect the provision of investment services through online/digital tools such as malicious cyber activity and should have in place arrangements able to mitigate those risks.

Particular attention should be paid by firms to recording and documentation obligations when providing robo-advice.

Contact

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