

AFME Response to ESMA Consultation Paper: Guidelines on certain aspects of the MiFID suitability requirements.

To: ESMA

Date: 24 February 2012

Submitted online to www.esma.europa.eu

Summary:

AFME welcomes the opportunity to comment on ESMA's draft Guidelines.

Our member firms are supportive of the high-level principles expressed in the guidelines and ESMA's desire to enhance clarity and foster convergence in the implementation of certain aspects of the MiFID 1 suitability requirements. We believe the guidelines will help investment firms to improve their implementation of the requirements thus strengthening investor protection.

There are a number of detailed points and drafting suggestions, however that we have highlighted in our detailed response in order to ensure that the guidelines work well in practice and can be applied in a proportionate and pragmatic way across the EEA.

We note that ESMA states that the Guidelines shall apply 30 days after publication. This would appear an unrealistically short implementation timescale. We would therefore strongly suggest that ESMA should allow 3-6 months to allow firms and regulators to either implement the new Guidelines or verify that their existing policies and procedures are aligned with the guidelines.

We would be happy to provide further detail on any of our comments if ESMA would find this helpful.

Yours faithfully

Angela Teke

Managing Director, Compliance Division

angela.teke@afme.eu

Tel: 0207 7439369

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General remarks:

- As there are slight discrepancies in the numbering between the main consultation paper text and ANNEX 3 of the consultation paper, references to Guideline numbers quoted shall refer to the paragraph references in the main body of the consultation paper. Guidelines to which we have provided concrete drafting amendments in Annex 1 have been flagged*.
- We appreciate the helpful guidance and elucidation the Guidelines provide in many instances, however, we would strongly suggest that where the Guidelines refer to specific sections in MiFID then the existing MiFID wording should be utilised as far as possible. Otherwise there is a risk of unintentionally introducing uncertainty through liberal re-interpretation or paraphrasing of the existing carefully calibrated MiFID requirements.
- Overall the Guidelines need to be implemented in a flexible and non-prescriptive way and specific regard needs to be paid to the needs of different client categories with the current guidelines appearing relatively “retail-client” centric.
- In Paragraph 10 of the consultation, ESMA states that “given the differences between firms in size, structure and business, the measures put in place to collect and assess client information as part of the suitability process should be best suited to the nature and circumstances of each firm.” We welcome ESMA’s recognition that firms are different and recognise that size may impact the method of collection, however, we are not convinced that size of firm should impact the way in which the firm assesses the information.
- Paragraph 11 of the consultation requires firms to adopt arrangements which enable it to meet the MiFID suitability requirements on an “ongoing and consistent basis”. As there is no requirement for ongoing suitability assessments in MiFID 1 (or indeed in the current MiFID 2 proposals) we are not clear what the use of the word “ongoing” implies in this context and would suggest ESMA delete such references as they would go over and beyond the current MiFID requirements.

Information to client about the suitability assessment

Q1: Do you agree that information provided by investment firms about the services they offer should include information about the reason for assessing suitability? Please also state the reasons for your answer.

Yes, we agree with the principle of the Guideline and believe that better client understanding about the reasons for assessing suitability and the importance of this should aid firms in collecting the necessary information. However, this requirement should be applied proportionally, pragmatically and in the course of business without for example requiring firms to repaper existing clients.

With regard to Guideline 17*, the statement that “investment firms should highlight to the client that it is important to gather complete and accurate information so that the firm can recommend the most suitable product or service for the client”, would appear to go beyond the obligations under MiFID in a number of aspects:

- a. MiFID does not require a firm to ensure that the firm recommends the *most* suitable product – only that the transaction is suitable. See Article 19(4) of MiFID.

- b. Article 19(4) does not require that the information should be “complete. The focus should be on gathering such information as is necessary to deliver a suitable outcome, by reference to the service or investment contemplated.

Guideline 19* states that “firms should avoid stating... that it is the client ...who establishes his own risk profile.” MiFID indicates that a client’s risk profile is part of the client’s investment objective and that information regarding the client’s investment objectives should be obtained from the client. On that basis, the client is responsible for providing his risk profile to the firm. Although we are supportive of what ESMA is trying to address, on balance we would suggest to delete the words “or that it is the client who establishes his own risk profile.” ESMA’s point is adequately made by making it clear that it is the firm’s responsibility to determine suitability and a client’s risk profile (however way that is established) is only one part of that process.

Arrangements necessary to understand client and investment

Q2: Do you agree that investment firms should establish, implement and maintain policies and procedures necessary to be able to obtain an appropriate understanding regarding both the essential facts about their clients, and the characteristics of financial instruments available for those clients?

Yes we agree. However, the criteria quoted in Guideline 22 (age, marital status, family situation etc) as necessary elements of client information, should be neither deemed exhaustive nor compulsory and firms should be able to use their discretion in determining which specific information items need to be obtained from their clients in order to undertake the suitability assessment for specific products. This will be especially the case for firms dealing with professional clients.

Q3: Do you agree that investment firms should ensure that staff involved in material aspects of the suitability process have the skills and the expertise to discharge their responsibilities?

Yes we agree that staff providing investment advice and portfolio management should be suitably qualified and experienced.

Q4: Do you agree that investment firms should determine the extent of information to be collected about the client taking in to account the features of the service, the financial instrument and the client in any given circumstance?

Yes we agree as long as the Guidelines are applied proportionally and pragmatically. However with regard to the detailed criteria which are quoted as necessary elements of client information, these are heavily focused on retail clients and should be neither deemed exhaustive nor compulsory and firms should be able to use their discretion in determining which specific information items need to be obtained from their clients in order to undertake the suitability assessment for specific products.

Draft Guideline 27* states: “investment firms should consider in relation to a client’s knowledge and experience, financial situation and investment objectives “c) the nature, needs and circumstances of the client”. It is not clear how section c) differs from a client’s knowledge, experience, financial situation and investment objectives and or/what ESMA is seeking to add to the existing criteria. We would therefore recommend deleting c).

With regard to draft Guidelines 27 -29, ESMA uses the terms “risky” and “illiquid” to describe financial instruments. These terms are not defined under MiFID and it is unclear what they are intended to capture.

There has been considerable debate under MiFID 1 regarding the complex and non-complex nature of instruments under MiFD and introducing new concepts may lead to uncertainty and divergent regulatory interpretation across the EEA.

The Commission's Background Note of February 2006 covering appropriateness, published to accompany its draft Level 2 Directive, for example commented that it is important to note that the complexity of a financial instrument per se is not necessarily synonymous with the risk associated with that instrument. Rather, complexity for the purposes of the Directive is determined by the way that an instrument is structured. We would therefore suggest that ESMA's Guidelines relate to complex products as defined by MiFID (for example Guideline 29 does not refer to complexity at all).

With regards to Guideline 28* the fact the instrument is complex should be one factor used by the firm in determining what information is required but the guidance should avoid being too prescriptive or introducing the concept of relativity (in terms of depth of information) which is potentially confusing.

The categories of information listed in Guideline 29* could, potentially, be relevant to any transaction. We would also suggest that this Guideline is renumbered as Guideline 27 and is not limited in its application to particular instruments.

We strongly welcome ESMA's confirmation that firms providing investment advice/portfolio management service to "per se" professionals can assume that these clients have the necessary knowledge and experience (and therefore firms are not required to obtain additional information on this point). We also agree that firms can assume that "per se" professionals are able to financially bear any related risks consistent with their investment objectives.

Reliability of client information

Q5: Do you agree that investment firms should take reasonable steps (and, in particular, those out-lined above) to ensure that the information collected about clients is reliable and consistent?

Whilst we agree that it is important for investment firms to use certain objective measures to verify the information provided by clients, we are concerned that the Guideline* states that firms should "not rely on the client's self-assessment". Firms should not rely on the information "unduly" or against "conflicting evidence" but there should be no automatic presumption that the information provided is unreliable. We agree that firms should make all reasonable efforts in obtaining accurate information. However, they should not have to become detectives in questioning bona fide information provided by established clients unless there are good reasons to do so. This is also in line with Article 37(3) of the Implementing Directive which states that firms "shall be entitled to rely on the information provided by its clients or potential clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete".

We agree that ideally firms should take a holistic view of information provided by clients and "take steps to ensure the consistency of client information", but note that this may be difficult to realise in practice due to operational and systems difficulties. For example, a client may have different accounts with different parts of a financial services group but staff may not have access to information held by other parts of the group and will therefore not be able to identify or act upon any inconsistencies or inaccuracies.

Updating client information

Q6: Do you agree that where an investment firm has an ongoing relationship with the client, it should establish appropriate procedures in order to maintain adequate and updated information about the client?

Yes we agree in principle, but note that these procedures are likely to differ substantially according to the nature and type of the client e.g. retail versus professional and would suggest that the Guideline should reflect this.

Client information for legal entities or groups

Q7: Do you agree that regarding client information for legal entities or groups, the investment firm and the client should agree on how the relevant client information will be determined and, as a minimum, information should be collected on the financial situation and investment objectives of the beneficiary of the investment advice or portfolio management services ('end client')?

Yes we agree in principle that the firm and client should agree on how the relevant information will be determined. However we have a number of detailed comments regarding the applicability of the guideline in specific circumstances.

Overall we would recommend that ESMA's approach provides sufficient flexibility regarding the term "beneficiary" in relation to trusts, companies and other vehicles used for investments.

ESMA's use of the term "beneficiary(ies)" in relation to legal entities (such as a company) is unhelpful and potentially confusing, without further elaboration. Where the client is in the form of a company, the starting point would be that the company is the beneficiary but there may be reasons why the firm might look beyond the company – for example, where the legal entity is a personal holding company and is, in some respects, the alter ego of the ultimate investor. If the term is to be retained it should be further clarified/defined by reference to illustrative, not prescriptive, examples.

Additionally where the client is in the form of a trust, ESMA's guidance that information should be collected on the financial situation and investment objectives of the beneficiary(ies) is too prescriptive. For example:

- The firm may not have access to information about the beneficiaries, or the trust may have a discretionary class of beneficiaries.
- It may in fact be more appropriate for the financial situation and investment objectives to be determined by reference to the trust itself, as if it were an entity and the ultimate beneficial owner.

With regard to Guideline 43* we would recommend that the reference to a married couple, as representing an example where a representative might not have been appointed, is removed. Married couples may or may not appoint a representative. There should be no implicit presumption that they are unlikely to or any suggestion that they should be singled out for special consideration.

Given the range of issues identified, we would suggest that ESMA's guidance should be provided as one approach the firm should consider, which may or may not be appropriate, depending on the particular circumstances thus allowing the necessary flexibility.

Arrangements necessary to ensure the suitability of an investment

Q8: Do you agree that in order to match clients with suitable investments, investment firms should establish arrangements to ensure that they consistently take into account all available information about the client and all characteristics of the investments considered in the suitability assessment?

We agree with the principle of this Guideline, however in assessing a firm's compliance with the Guideline it will be important to focus on achieving appropriate client outcomes (i.e. a suitable product having been recommended). A sweeping generalisation such as "tools that classify clients or financial instruments broadly would not be fit for purpose" would appear inappropriate in this context and should be removed from Guideline 45. Furthermore firms should be required to take into account all *relevant* characteristics of the investments.

Paragraph a) of Guideline 46* states that firms should ensure that "the advisory and portfolio management services provided to the client take into account an appropriate degree of risk diversification." However, a client may be seeing a specific investment return or access to a specific asset class. In such circumstances it should be made clear that considerations regarding risk diversification may not be relevant.

Paragraph 46 c) of ESMA's guidance refers to the ability of the client to "bear any possible losses resulting from his investments" whereas MiFID requires that the recommended transaction is such that the client is "able financially to bear any related investment risks consistent with his investment objectives". These are quite different requirements as all investments in theory could be lost totally and in fact in Guideline 33 ESMA does use the correct terminology. ESMA's guidance should be redrafted to follow MiFID's narrower requirements. Also, it is not clear what ESMA intends by requiring the firm to ensure that the client's financial situation "allows him to finance his investments at any moment". Does this refer to situations where the client is leveraged and financing his investments through margin/borrowings? Given the lack of clarity we would suggest deleting the wording of "at any moment."

Recordkeeping

Q9: Do you agree that investment firms should establish and maintain record-keeping arrangements covering all relevant information about the suitability assessment? Please also state the reasons for your answer.

Yes, we agree in principle with the Guideline*, however whilst we agree that recordkeeping should be orderly, comprehensive, easily accessible and transparent, we do not believe that all suitability records should be "centralised" as long as records are easily accessible on demand to relevant staff and regulators. Requesting firms to centralise all their client information systems goes beyond the scope of MiFID 1 and is likely to cause costs which are disproportionate to the benefits obtained and could not be implemented within the timescales envisaged by ESMA for implementing the Guidelines.

We would also suggest that the reference to record-keeping arrangements being designed "to enable the detection of failure regarding the suitability assessment (such as mis-selling)" is somewhat unclear if not misleading. A recordkeeping system should be a tool designed to provide appropriate and comprehensive information in all circumstances, including routine enquiries by staff and clients, not just investigations into potential shortcomings which are likely to be rare and infrequent.

Annex I: Drafting Suggestions

Drafting suggestion: Reliability of client information

Investment firms should take reasonable steps to ensure that the information collected about client is reliable. In particular firms should:

- Not rely on clients' self assessment if they are aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.

Drafting suggestion Guideline 17:

"Investment firms should highlight to the client that it is important to gather sufficient and accurate information so that the firm can recommend a suitable product or service for the client".

Drafting suggestion Guideline 19:

In this regard, firms should avoid stating or giving the impression that it is the client who decides on the suitability of the investment, ~~or that it is the client who establishes his own risk profile~~ (for example, by....)

Drafting suggestion Guideline 27:

The extent of information collected may vary.....

- a) the type (including the complexity ~~and level of risk~~) of the financial instrument or transaction to be recommended or entered into;
- b) the nature and extent of the service;
- ~~c) the nature, needs and circumstances of the client.~~

Drafting suggestion Guideline 28:

In determining the information to be collected, investment firms should take into account the type of the financial instrument or transaction. For example, a firm should consider whether it requires additional information about the client when recommending complex financial instruments compared with the information it requires when recommending non-complex financial instruments. For example, where the financial instrument recommended does not present frequent opportunities to dispose of, redeem or otherwise realise that instrument, the firm should consider whether it has sufficient information regarding the length of time for which the client wishes to hold the investment and the extent of the client's liquid assets.

Drafting suggestion Guideline 29 (which we suggest is renumbered as Guideline 27):

For example, for risky or illiquid financial instruments, the 'necessary information' to be gathered may include some or all of the following elements with respect to the client's financial situation...."

Drafting suggestion Guideline 43:

Where no representative has been appointed, as may be the case for a group of natural persons (~~for example, a married couple~~), investment firms should adopt [...]

Drafting suggestion Guideline: Suitability of investment

In order to match clients with suitable investments, investment firms should establish policies and procedures to ensure that they consistently take into account:

- All relevant characteristics of the investments considered...

Drafting suggestion Guideline 45:

In this regard, the tools should be designed so that they take account of all the relevant specificities of each client or financial instrument. For example, tools that classify clients or financial instruments would not be fit for purpose.

Drafting suggest Guideline 46:

Policies and procedures established by the firm should enable it to ensure inter alia that:

- a) Where appropriate, the advisory and portfolio management services provided to the client take into account an appropriate degree of risk diversification.
- b) ...
- c) The financial situation of the client allows him to finance his investments ~~at any moment~~ and allows him financially to bear any related investment risks consistent with his investment objectives

Drafting suggestion Guideline: recordkeeping

Investment firms should:

Maintain adequate recording and retention arrangements to ensure ~~centralised~~ easily accessible, orderly and transparent record-keeping [...]