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Position Paper

ESMA consultation on guidelines on certain aspects of the MiFID II suitability requirements

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Federal Association
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On 13 July 2017, the European Securities and Markets Authority (ESMA) published its long-awaited consultation paper on the "Guidelines on certain aspects of the MiFID II suitability requirements" and invites for comments on this paper. ESMA's requirements will affect both the assessment of suitability of clients and the internal processes of investment firms for assessing suitability.

The ESMA guidelines are dedicated in particular to suitability assessment in the context of automated advice tools (robo-advice). In this respect, ESMA identifies three areas for action:

- the particularities of the provision of information for clients (without or only with limited communication options with personal contacts with the asset manager);
- the assessment of suitability itself (especially when using an online questionnaire with limited or no human interaction);
- the organisational measures to be taken by investment firms for the provision of digital advisory services.

Following the entry into force of MiFID II on 3 January 2018, the assessment of suitability will be based on Article 25 (2) of Directive 2014/65/EU on Markets in Financial Instruments (MiFID II) and Articles 54 and 55 of the Commission "Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and the Council as regards of organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive" (MiFID II).

Under the new regulatory regime in accordance with Section 64 (3) of the German Law on Securities Trading (hereinafter WpHG-E), asset managers are still obliged to assess the suitability of asset management in its specific form for the client. This includes information on

1. knowledge and experience of the client in dealing with certain types of financial instruments or investment services,
2. the client's financial circumstances, including his ability to bear losses; and
3. to obtain its investment objectives, including its risk tolerance.

In this respect, the requirements of the ESMA Guidelines are of particular interest in the field of digital asset management, so that special attention should be paid to the requirements of the ESMA Guidelines with regard to the digital aspects of the assessment of suitability.

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 welcome the fact that ESMA has taken into account the findings of studies on "behavioural finance" as part of the ESMA Guidelines update. We fully share ESMA's basic assumption that clients, at least a certain number of them, are susceptible to bias and to the way in which certain choices are presented. In many cases, financial decisions are at least partly influenced by rationally irrelevant aspects from the environment of the decision to be made, which can lead to suboptimal results. We also agree with ESMA that the assessment of suitability may be ineffective if it does not take account of this behavioural bias.

In order to avoid this, ESMA proposes a number of measures to achieve unbiased responses from the client's point of view, e.g. with regard to the layout and structure of the questionnaire, type of question and answer (e.g. "no response" as an answer option), simple language, etc. In fact, the way in which questions are presented can influence the answers and thus create or reinforce a client's bias. However, we believe that the existence of measures to achieve unbiased responses from clients is a well-intentioned but unattainable goal. In our opinion, it is not possible to carry out an assessment of suitability or to design the WpHG questionnaire in such a way that the client remains completely or largely unbiased.

ESMA's examples alone, which demonstrate how an unbiased answer to the questions can be promoted, show that these measures can only have a rudimentary influence on the bias or impartiality of clients. Changing the format of the questionnaire or questions, for example, may help one client, but the other may find it difficult to see an unbiased answer because of the format change. In addition, every question that is part of the assessment of suitability is pre-formulated by people who are biased (due to socialization, occupational/social influences).

In our view, it is therefore the responsibility of investment firms to be aware of the fact that the interviewed clients might be biased. This fact should then be taken into account when designing the questions, interpreting the client's answers and – to take asset management as an example – when selecting the suitable investment strategy for the client.

We believe that this objective can be achieved not so much by the measures proposed by ESMA as by standardising the assessment of suitability carried out by investment firms. With such a standardisation of the assessment, the same kind of answering of the questions (which are identical for each client) – irrespective of the questioner (whether it is a person, or – as in the case of digital asset management – an automated application) – always leads to the same result.

If the assessment of suitability is not carried out in a standardized manner, e.g. for different clients by different employees who evaluate the test results at their own discretion, this can – depending on the persons involved – lead to differing degrees of bias on the part of the client and to completely different evaluation results on the part of the asset manager. The more consistently the assessment of suitability follows an abstract logic and the more consistently the implementation of the determined logic is documented in the individual assessment, the better the client's bias can be addressed.
Also a standardized assessment of suitability does not prevent the client from being biased. The bias, however, is neutralized by the standardization of the test. Remaining distortions are measurable or recognizable and can be taken into account and documented when evaluating the assessment by the investment firms. At the same time, investment firms can put findings – gained for example from the systematic analysis of results or back testing, – into practice for all clients through rigorously adapting the standardization process.

In this respect, we would also like to take a slightly more differentiated view of the thesis that has been included in several parts of the consultation paper, namely that an “online questionnaire” and the associated limited or complete lack of contact between people (namely investment firms on the one hand and clients on the other), would make special (protection) measures necessary.

From our point of view, the decisive factor in the assessment of suitability is not the factor “man” or “machine”, but the degree of standardization of the assessment itself. The higher the degree of standardization by the respective investment firm, the less likely it is that the result will be incorrect and biased – irrespective of whether the test is performed by a human being or an automated application.

With regard to the terms “automated advice tools” and “robo-advice” used in the ESMA Guidelines, we suggest a definition of both terms that allows for the classification of the different forms of digital financial services. Especially in the area of investment advice and financial portfolio management, different digital options are possible and are already being used. In this respect, it would be helpful to know which of these digital services, from ESMA's point of view, fall under the term “automated advice tools” or “robo-advice” and which do not.

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.

With a view to obtaining information on the financial situation of the client (including his ability to bear losses) and on the investment objectives, ESMA has rationalised and clarified the existing rules. Taking the age of the client as an example, ESMA argues that this information would be an important factor leading to a correct assessment of the client investment objectives. ESMA illustrates this by looking at an older client who indicates a planned holding period of 20 years for his financial instruments. This information would indicate a possible inconsistency, unless the client is also interested in his succession planning.

From our perspective, the questions suggested by ESMA (e.g. regarding marital status) may but not necessarily have to allow to draw (indirect) conclusions about the financial situation and / or investment objectives of the client. In addition, questions of marital status or age are perceived as discriminatory by some clients.

We therefore recommend to ESMA to leave individual investment firms the scope to develop the questions which, within the framework of their assessment of suitability, will lead to the best possible results when it comes to obtaining information on the financial situation of the client and the investment objectives.

If well documented and standardized questions developed by the investment firm in question lead to valid and analysable results with regard to the objectives of the assessment of suitability (financial circumstances of the client and his investment objectives), then this option is preferable to a catalogue of questions specified by ESMA. This also sustainably promotes the quality for clients.

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.

ESMA proposes the use of appropriate systems and controls when using questionnaires to ensure that the information collected is consistent. These measures are important and must be implemented with great care, especially in the context of robo-advice.

In the guideline itself (guideline 4), ESMA states that the software, which determines risk profiles, also carries out coherence checks with regard to the responses given by the client. The aim is to identify inconsistencies between different answers.

Investment firms should in such cases contact the client to resolve material potential inconsistencies or inaccuracies. As an example, the contradiction between poor knowledge and experience on the one hand and a high risk affinity on the other is cited.

Like ESMA, we also see the need to use coherence checks to identify any contradictions in the client's responses to the assessment of suitability.

However, when such inconsistencies arise, we advocate a differentiated approach:
If contradictions arise, which can only be clarified by contacting and consulting the client, then contacting the client is the right way to proceed. However, if contradictions can already be pointed out and remedied in the (automated) assessment of suitability by means of reference to the client, a corresponding note (e.g. in the form of a pop-up window with a corresponding information text) should be sufficient. In this case, a separate outreach is not necessary. In particular, it should be made clear that contradictions can be perfectly understandable. Thus, a client can have higher expenditures than income per month (consumption of materials) and still invest a part of his assets in the long term, if the available assets provide sufficient substance for it. Contradictions should therefore not, per se,

exclude investments. Instead, in the event of confirmation by the client, these inconsistencies should be taken into account by the investment form in an appropriate manner when making recommendations or, in the case of asset management, when making investment decisions, following a corresponding indication to rule out misunderstandings.