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13 October 2017

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

Re: Consultation paper on the guidelines on certain aspects of the MiFID II suitability requirements.

Dear Sir/Madam,

CFA Institute appreciates the opportunity to comment on ESMA's consultation paper on guidelines on certain aspects of the MiFID II suitability requirements.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 140,000 members in 150 countries and territories, including 133,000 Chartered Financial Analyst® charterholders, and 147 member societies.

Specific Comments

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.

CFA Institute is pleased to see ESMA taking into account behavioural insights in providing guidelines for how information should be presented in the suitability assessment, specifically in relation to robo-advice. We agree that ESMA has identified the key behavioural finance findings, which align with those presented in our 2017 report[1] 'Designing a European Summary Prospectus using Behavioural Insights'. Guidelines that ensure questions in a suitability questionnaire are drafted to avoid perceptive or cognitive distortion from impairing investors' answers are welcome.

This is particularly important in the context of financial advice being provided without much human interaction, often solely via electronic disclosures. The lack of human interaction means that the investor has less information and context on which to base his / her decision. It is a one-way communication as opposed to two-way communication in the case of a conversation with a human advisor. The colour and context of human interaction is absent in the case of robo advice. In these circumstances, the quality of the information disclosure becomes even more important in the investment decision making process.

We also support ESMA's efforts to reduce the 'black box' phenomenon surrounding robo advice. The guidelines in paragraph 39 that encourage firms to provide information about the purpose and basic functioning of the algorithm, the circumstances that may cause the firm to override the algorithm, and

[1] https://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2017.n2.1.aspx

the involvement by third parties in the development, management, or ownership of the algorithm, are welcome.

In addition, we believe the firm should not be able to override the algorithm unless it is in the best interests of the client, and that the alternative advice or recommendation (as a result of the over-ride) can be shown objectively to be to be in the best interests of the client. The functioning of the algorithm and the development, management and oversight of the algorithm should be underpinned by ethical principles that place client interests first.

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.

We agree with ESMA's guidelines suggesting that firms need to design questionnaires taking into account behavioural biases that could influence client answers, and as a result drive unsuitable investment advice. Paragraph 43 highlights some interesting drawbacks of the analysis of existing questionnaires, including: the lack of clarity of the questions, confusing page layout that may be aimed at steering investor responses, and the overuse of 'No Answer' as a valid response. We welcome ESMA's focus on providing guidelines for common sense checks, such as questioning an elderly investor replying to an investment horizon question with a response of 20 or 30 years.

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

CFA Institute believes it may benefit the MiFID II suitability guidelines if ESMA were to present, as an example for firms, a non-binding template for a suitability questionnaire that would follow all recommendations listed by ESMA in this consultation document.

The ultimate format of such a questionnaire should assess risk tolerance on the basis of both the willingness and ability to bear losses. The investor's preferences for risk and their current financial situation (including holdings of cash and other liquid assets, as well as sources of income) should inform the ability to bear losses.

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 are pleased that ESMA has recognised that existing suitability questionnaires are often drafted in a way that does not effectively assess the knowledge, experience, risk tolerance, and investment horizon of clients. Clients are prone to systematically over-estimate their knowledge and risk tolerance due to behavioural biases. We would like to support the suggestions in paragraph 51 of Annex III, such as determining the client's understanding of the risk-return trade off and risk diversification through practical examples/situations including the use of graphs or positive/ negative scenarios. Other ESMA suggestsions such as asking the client how much money they are willing to lose rather than a generic low/medium/high risk tolerance question should also improve the reliability of investor information. However, there is a danger that if investors are to be presented with frequent and stark representations of the downside risk of investing it would bias their responses to be unnaturally risk-averse. This outcome may not improve investor outcomes, particularly if it resulted in investors forgoing investment decisions altogether.

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

No comment.

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.

No comment.

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.

CFA Institute wishes to highlight the importance of paragraph 71 of Annex III which reminds firms that an assessment needs to be made on the complexity of products, and that this complexity needs to be matched with the characteristics or profile attributed to the client, particularly as it relates to client knowledge/ experience. This applies in particular to products, such as convertible bonds, which may change their nature into shares under particular circumstances.

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.

CFA Institute broadly agrees with the additional guidance provided in Annex III regarding the arrangements necessary to ensure the suitability of an investment. In particular, we welcome the guidelines in paragraph 85 that relate to ensuring the consistency of the suitability assessment conducted through automated tools. This guideline encourages firms to regularly monitor and test the algorithms that underpin the recommendations. In addition, firms should establish system-design documentation, including techniques such as decision trees, to clearly set out the purpose of the algorithms, and have a documented testing strategy. Changes to the algorithms should be managed according to defined policies and procedures and records kept of any changes. Finally, policies and procedures should be in place to detect errors within the algorithm, for example errors that result in erroneous or unsuitable advice.

We believe there is scope to improve paragraph 86 of Annex III which sets out additional guidelines for firms providing robo advice. The current text encourages firms to ensure that:

- The suitability questionnaire elicits sufficient information to allow the firm to conclude that the advice is suitable for the client;
- The prevention and detection of, and respose to, cybersecurity threats;
- The protection of client accounts; and
- The use of social media in connection with the marketing of robo-advice services.

We think it would benefit investor protections to prescribe some minimum standards for these guidelines, for example:

- The minimum acceptable information to be elicited from the questionnaire;
- The types of business continuity processes that need to be in place;
- Some minimum acceptable level of technical safeguards for client data; and

- Rules around the use of client data in marketing on social and other electronic media, with reference to the General Data Protection Regulation (GDPR) entering into effect in May 2018.

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.

CFA Institute is supportive of firms having suitability policies and procedures to determine whether possible investment alternatives exist, taking into account the cost and complexity of the products and their possible alternatives, before a decision is made on an investment recommendation.

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.

No comment.

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.

CFA Institute wishes to state its support for ESMA's approach in paragraph 102 of Annex III, which suggests that knowledge of, and expertise in the suitability assessment process is necessary even for staff that do not directly face clients but who are involved in designing, programming, or administering the algorithms that produce the assessment.

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

No comment.

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 comment.

CFA Institute

Concluding Remarks

We welcome this opportunity to comment on the guidelines for certain aspects of the MiFID II suitability requirements. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

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