European Securities and Markets Authority

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PUBLIC STATEMENT

ESMA presents the results of the 2020 Common Supervisory Action (CSA) on MiFID II suitability requirements

Background

1. In February 2020 ESMA announced on its website the launch of a common supervisory action (CSA) with national competent authorities (NCAs) on the application of MiFID II suitability rules across the European Union (EU).

2. The CSA was set up to allow ESMA and the NCAs to assess the progress made by intermediaries in the application of this key requirement, including on whether and how the costs and complexity of investment products are taken into account by firms when recommending an investment product to a client. ESMA had updated its guidelines on the topic in 2018[1] and had also published a supervisory briefing[2] on suitability, both of which were considered for the 2020 CSA.

3. The CSA has been performed based on a common approach and high level methodology developed at ESMA level in 2019. The CSA assessment framework, including scope, methodology, supervisory expectations, and timeline is the result of a joint effort to carry out comprehensive supervisory action in a convergent manner.

4. In announcing the CSA to the public, ESMA noted that the initiative, and the related sharing of practices across NCAs, would help ensure consistent implementation and application of EU rules and enhance the protection of investors as well as improve NCA's understanding of supervisory approaches in line with ESMA objectives. This CSA contributes to fulfilling ESMA's mandate on building a common supervisory culture among NCAs to promote sound, efficient, and consistent supervision throughout the EU. ESMA's promotion of supervisory convergence is done in close cooperation with NCAs.

Overview of the execution of the CSA by NCAs

5. 26 EU and EEA NCAs participated in this CSA and shared knowledge and experiences at the level of ESMA throughout 2020, to ensure supervisory convergence in the way they

[1] ESMA35-43-869.
[2] ESMA35-43-1206.

supervise the MiFID II suitability requirements and ultimately enhance the protection of investors across EU and EEA Member States.

6. A total of 206 firms where included in the CSA sample, 104 of which credit institutions (CIs), and 83 investment firms (IFs); a few branches of investment firms passported in other Member States and fund management companies were also included in the CSA sample. NCAs used different criteria to select a representative sample for their market. Criteria used included total number of clients, market share (investment services), volume of transactions subject to the assessment of suitability and overall size of the firm.

7. The development of the COVID-19 emergency impacted the supervisory plans of many NCAs. Nonetheless, various NCAs did not limit themselves to purely desk-based approaches, but also made use of various tools (such as video/audio conferencing tools) to perform inspection procedures and to test the overall effectiveness of firms' policies and procedures. More specifically, 206 supervisory actions were conducted by NCAs for this CSA (including desk-based and on-site reviews through the use of remote interviews).

8. With the CSA, NCAs also reviewed concrete cases of suitability assessments and (where relevant) reviewed recorded telephone conversations to verify whether a firm's policies and procedures were correctly applied.

Main findings

9. The 2020 CSA has shown an adequate level of firms' compliance with key elements of the suitability requirements that were already regulated under MiFID I such as firms' understanding of products and clients and the processes and procedures to ensure the suitability of investments. However, shortcomings and areas of improvement have emerged with regard to some of the new requirements introduced by MiFID II, notably the requirement to consider the cost and complexity of equivalent products, the costs and benefits of switching investments and suitability reports. More details are provided below.

Obtaining information from clients with regard to clients' knowledge and experience, financial situation and investment objectives

10. A key element of the MiFID II requirements is the need for firms to collect all necessary information to enable firms to recommend to the client or potential client the investment services and financial instruments that are suitable for him/her. On this aspect, there appears to be, for most firms and across most Member States, a satisfactory level of information gathering, both in terms of breadth of information collected and details. Depending on the Member State and/or the firm, practices may vary between firms having one questionnaire for all clients and firms having different questionnaires depending on the investment service and/or product offered or client group.

11. While the 2018 guidelines noted that it would be a good practice for firms to collect information about the client's or potential client's ESG preferences, the CSA showed that,

as of today, the vast majority of firms in the CSA sample do not yet incorporate the collection and analysis of such information into their suitability policies and procedures.

12. To ensure that they have collected all necessary information to proceed with the suitability assessment and/or to address inconsistencies in the client's or potential client's answers, it appears that firms rely on a variety of mechanisms including the following: automated checks incorporated into their system, manual checks performed by the advisor or by a different team (back office, account opening team, compliance team) on the completeness and coherence of responses provided by the client. A few NCAs reported issues in the adequacy of the consistency checks performed by firms in their jurisdiction.

13. A number of NCAs also reported that some firms in their Member State unduly rely on the client's or potential client's self-assessment to some degree, some more extensively than others, and without counterbalancing such assessment with objective criteria[3]

14. It also emerged that, in a few jurisdictions, some firms do not appraise the client's ability to bear losses, relying instead on the client's risk tolerance despite the two covering different aspects of the suitability assessment. While these firms are a minority, their number is, in some Member States, not negligible.

15. Regarding control functions' involvement in the approval and/or review of the questionnaire (especially the compliance function), it appears from NCAs' reports that the extent of such involvement is very disparate across both Member States and firms. In most cases, the compliance function is, to some extent, part of the design and/or review process of the questionnaire; however, in a limited but non-negligible number of firms, its role is limited to ensuring that the questionnaire complies with legal requirements, without controlling other aspects such as layout, clarity, exhaustiveness or comprehensibility.

16. With respect to the updating of client information, the vast majority of firms appears to have in place policies and procedures to ensure that the information collected does not become out of date, inaccurate or incomplete. However, the frequency of updates varies greatly between firms as frequencies reported by NCAs range from annually to up to every six years (for clients in the lowest risk category) whilst some firms perform fact-finding exercises at each interaction with their clients. The majority of firms also have embedded in their policies, procedures or systems other triggers that warrant an update to the client profile. Most firms also encourage clients to inform them where significant changes to the information originally provided occur. Most NCAs reported that the majority of firms in their Member States have put in place policies and procedures to ensure that the service cannot be provided without the information being updated.

17. Finally, NCAs investigated whether firms have in place arrangements and procedures to mitigate the risk that clients would be induced to change their own profile so that a product otherwise unsuitable would appear suitable. Several NCAs reported that such mechanisms

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[3] ESMA recalls that guidance on the topics of the 'extent of information to be collected from clients' and the 'reliability of client information' is provided in guidelines 2 and 4 of the ESMA guidelines on suitability.

lack or are insufficiently robust. However, several others reported the adoption by firms of practices such as the following: (i) cooling off periods or frozen periods during which the previous profile is still valid, or (ii) limits to the number of times the client profile can be updated during a set period, or (iii) prior authorisation by a central structure of the firm.

Arrangements necessary to understand investment products

18. In order to recommend suitable products to their clients, it is essential that firms are able to understand the characteristics, nature and features (including costs and risks) of the investment products. In this respect, in a large majority of Member States, most firms have set up and maintain adequate policies, procedures and tools to comply with the requirements in this area.

19. A majority of firms seem to rely on their product governance policies and procedures, to varying degrees. In addition, in most Member States, firms' policies and procedures differ greatly in quality and comprehensiveness depending on the nature, scale and complexity of the firm in question as well as the suite of products on offer and their complexity.

20. Whilst it seems that in many jurisdictions firms rely on more than one market data provider for the flows of data underlying their product assessment, a couple of NCAs reported that their firms only rely on one data service provider. In such Member States, however, firms also make use of other sources of information such as manufacturers' or issuers' documentation, internal resources as well as direct contacts with issuers/manufacturers.

21. A few NCAs also observed the following situations:

    - the breadth of the product categories defined by a minority of firms may be too wide, leading such firms to allocate products between overly general categories of products (for instance, complex and non-complex products);

    - a small number of firms rely on staff's expertise instead of implementing and maintaining defined policies and procedures to understand products;

    - an investment product eligibility to bail-in may not always be taken into account in firms' assessment of such product's credit risk.

Arrangements necessary to ensure the suitability of an investment

22. The majority of NCAs reported that most firms in their Member States take all collected information into account as part of the suitability assessment.

23. With regards to the approaches to the suitability assessment adopted across Member States, the majority of sampled firms employ algorithms and automated systems to underpin the suitability test. The level of details and sophistication of these systems varies across Member States and firms. In general, these systems assign different weights and scores to clients' information to evaluate the suitability of a product. Some NCAs reported

more advanced approaches where the suitability assessments are based on the consideration of the client's portfolio as a whole to ensure that, for each recommendation, it is verified that the resulting portfolio of the client is suitable on the basis of client's personal circumstances. Suitability assessments are often structured in a number of steps and are based on a number of key parameters to be considered.

24. Finally, the role of the compliance function also varies greatly across firms as some firms will have their compliance function involved or controlling in some way all steps of the suitability assessment (development of the questionnaire and its review, controls on the algorithms/processes underpinning the suitability test, ex-ante checks on the client profiles attributed to clients, ex-post controls on the attribution of client profiles and whether recommendations made are suitable or not) whilst, in other firms, the role of the compliance function will be limited to ex-post and periodic (even sporadic) checks.

Cost and complexity of equivalent products

25. A key element of the MiFID II requirement mentioned above, is the need for firms to cluster products into broadly equivalent categories to be able to compare them in terms of cost and complexity. However, there appears to be different understandings across firms and across different jurisdictions of what should be regarded as "equivalent products" and practices. For example:

    - some classify equivalent products (within the product range of the firm) on the basis of a similar risk-return-profile, some refer to a similar target market and others to the asset class;
    - differences emerge on the scope of the products subject to 'clustering';
    - significant differences emerge in relation to number, composition and granularity of clusters.

26. In this respect, some NCAs observed potential issues in the practices adopted by some firms. For example:

    - some firms treat every product in a given product group as equivalent even if their costs and complexity are different (for example bond funds are treated as equivalent regardless of the average maturity, sector, region or type of issuers they focus on);
    - a few firms do not define any equivalent products at all, effectively treating all products as separate product groups;
    - some NCA reported that firms and branches within their sample did not have policies and procedures in place to assess and compare costs and complexity of products or did not document and maintain records about the assessments performed.

27. The ESMA guidelines on suitability noted that *“where a firm uses common portfolio strategies or model investment propositions that apply to different clients with the same investment profile (as determined by the firm), the assessment of cost and complexity for 'equivalent’ products could be done on a higher level, centrally, (for example within an investment committee or any other committee defining common portfolio strategies or model investment propositions) 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”*. What emerged from the CSA is that, for those firms that implemented policies and procedures, the assessment of cost and complexity for equivalent products is indeed mainly performed centrally in the context of the product approval process (within the relevant committees) and less attention is brought to it at the level of the point of sale when an advisor selects a financial instrument among different suitable alternatives (client level). These processes are therefore applied ex-ante, i.e. at the stage when the firm’s product offering (for advisory services) is defined (or updated).

28. In this respect, the analysis of sampled firms’ policies and procedures shows that the new MiFID II obligation of assessing equivalent products, taking into account cost and complexity, has mainly been implemented in practice as a means of defining a more efficient assortment of products for the provision of investment advice (“efficiency test”). In practice, this means that firms aim to ensure that, within each cluster of equivalent products the level of costs is comparable, by often excluding, therefore, products characterised by higher costs (“outliers”). This is however not true for all firms/Member States.

29. The ESMA guidelines noted that “*Firms should be able to justify those situations where a more costly or complex product is chosen or recommended over an equivalent product*” and “*Firms should document and keep records about these decisions, as these decisions should deserve specific attention from control functions within the firm*”. Mixed results emerge from the CSA. While this could be partially explained by the ex-ante/centralised approach to the control on complexity (see above) - i.e. decisions are taken on an ex-ante basis and do not manifest themselves at point of sale – it must be noted that a significant number of NCAs noted a lack of sufficient internal documentation within firms on this important topic.

30. Finally, different results also emerged on the topic of if and how firms inform clients about the decision to choose more costly or more complex financial instruments over an equivalent one. The ESMA guidelines noted that “*when providing investment advice firms could, for specific well-defined reasons, also decide to inform the client about the decision to choose the more costly and complex financial instrument*”. The CSA evidenced that only some firms inform clients through the suitability report, while others noted that the information is provided in face-to-face meetings (without appropriate records) or not provided at all.

Costs and benefits of switching investments

31. Regarding the cost/benefit analysis of switching investments, as introduced in the MiFID II framework, there seems to be no common interpretation of what is to be considered "switching". Most firms appear to have adopted broad definitions such as "any sale (from the perspective of the client) or disinvestment where a corresponding purchase is already intended, irrespective of the timing". Some NCAs however reported the use of narrower definitions that could increase the risk of circumventing the MiFID II requirements. For example:

    - defining "switching" as replacing a product with a very similar one;
    - limiting "switching" to buy and sell recommendations that take place at the same time;
    - only defining switching in the context of "portfolio approach" advisory services;
    - excluding all rebalancing of portfolios from the scope of the obligations arising from "switching", (in contrast to paragraph 89 of the ESMA guidelines).

    There is also evidence of some limited cases of explicit exclusions from the perimeter of controls over switches. In particular:

    - the divestment from any financial product for the subsequent investment in UCITS, as the firm believes the benefit of diversification intrinsic to these instruments would not require any assessment of the related costs of switching;
    - switches between UCITS (defined "technical" switches), as according to the relevant bank these would not usually determine an increase in costs for the client and even if they did, such additional costs would always be "justified" a priori by the pursuit of different investment objectives;
    - situations where the increase of costs as a result of a switch is below a certain threshold, pre-defined by the firm.

32. Furthermore, some models showed limits in the way costs and benefits are quantified, with potential negative effects in terms of overestimating benefits or underestimating costs.

33. On the other hand, controls and operational measures that have been adopted by firms to ensure that the MiFID II requirements are not circumvented include:

    - prohibiting to split up investments and disinvestments in different days;
    - operational blocks inhibiting the possibility of recommending a purchase within a certain time period (for example 3 or 5 days) following an advice to sell;

- a general rule not to switch investments if the financial instrument has been in the portfolio for less than one year or if the financial instrument reaches its maturity date within the next 6 months (with some exceptions);

- monitoring by the compliance function (through sample-based controls) of the correct application of the above measures, in order to detect ex-post any irregular conduct.

34. In relation to the mechanisms adopted to conduct the cost/benefit analysis of switches, the following was noted:

    - firms consider the impacts of both the purchase and sale in assessing the suitability of a switch, to ensure that the recommendation to change investments and conclude related transactions do not result in costs that exceed the benefits for the client impacted by the change;

    - with regards to portfolios, it was observed that firms generally adopt mechanisms aimed at comparing the changes in the costs a client's portfolio would incur as a result of a divestment/investment with the related changes in terms of benefits. Notwithstanding the specificities of the single models, it was generally reported that firms perform a comparison between the composition of the old and the new portfolio, taking into consideration the costs of the switches but also the benefits in terms of expected return and the enhancements to the quality of the portfolio;

    - NCAs noted the use of IT tools by firms that support the process of the switching. For example, it was reported that for some firms the cost-benefit analysis is integrated in the transaction process, with the analysis being produced automatically when the transaction is marked as a switch by the advisors. Other firms have put in place arrangements that require switches to be explicitly justified and recorded in the firms' online systems;

    - some of the firms surveyed have not formalised specific policies and procedures for analysing the costs and benefits of switching investments, which prevent firms to be able to reasonably demonstrate that the expected benefits of the switch outweigh the costs.

35. Finally, different approaches emerged on whether and how firms inform clients about the assessment of costs and benefits done for a switch. For many firms the result of the cost/benefit analysis and/or the justification for switching investments were not sufficiently explicit (or were even erroneous) in the suitability reports and sometimes were only explained verbally to the client.

Suitability Report (both initial and ongoing reports provided to clients)

36. Based on the outcome of the CSA, while the majority of firms comply with the formal requirement of providing clients with a suitability report (often with dedicated IT systems), a variety of approaches has emerged on how this is done. In particular:

    - a large majority of statements were automatically generated and contained only standardised text which was not personalised, hence not referring to the particular client information. These reports failed to illustrate how and why the advice provided is consistent with the client's circumstances. Typically, firms relied on a generic statement such as 'Based on the information provided by you, we have concluded that the above transaction is suitable for you';

    - some NCAs found that the information required by MiFID II was missing in the suitability reports;

    - some firms simply did not provide suitability reports to clients or simply submitted print screens from data providers' websites, regarding the proposed investments;

    - in some cases, suitability reports were not submitted to clients when the advice given was to sell investment products.

37. As mentioned above, the majority of firms use automated processes to produce and deliver the suitability report so no major issues emerged in relation to the timing of the delivery to the client, although in a limited number of cases suitability reports were submitted to the client after the transaction or only once in a year.

Next steps

38. Based on the results of the CSA, ESMA will update, in 2021/2022, its guidelines on suitability to address, where needed, some areas where a lack of convergence has emerged or/and to further clarify some of the new MiFID II requirements. In this context, it will also be possible to complement the guidelines with relevant examples of good and poor practices emerged from the CSA. The review of the guidelines will also aim to align the suitability guidelines to the guidelines on appropriateness and execution-only[4] and to the revised MiFID II Delegated Regulation on the topic of sustainable finance.

39. NCAs will undertake follow-up actions on individual cases, where needed, to ensure that regulatory breaches as well as other shortcomings or weaknesses identified are remedied.

40. It is reminded that market participants should ensure compliance with all relevant MiFID II regulatory requirements at all times.

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[4] The ESMA MiFID II guidelines on appropriateness and execution-only have undergone a public consultation (Ref: ESMA35-36-2159) and will be finalised and published in the upcoming months.