

ADVICE TO ESMA

SMSG Advice on Assessment of Knowledge and Competence in the Context of MiFID II (Consultation Paper ESMA/2015/753 of 23 April 2015).

I. Executive summary

In the context of knowledge and competence requirements, the SMSG first of all re-iterates some of its earlier advices. These referred to the assessment and certification of knowledge and competence; the need for training and support and the usefulness of a dialogue with employee representatives, where available, on the needs for training and sales policy in general. The SMSG believes that these three elements can reinforce one another.

While the SMSG agrees that the guidelines should be principle-based rather than overly prescriptive, it at the same time calls for supervisory convergence, peer reviews and transparency on the criteria used by the different member states, as this could facilitate the transfer of best practices and mutual recognition. Also, the SMSG considers it important that passporting does not result in a watering down of knowledge and competence criteria.

While there may be reasons to set higher standards depending on the risks, sophistication and the complexity of the products being advised/sold, the SMSG believes that the ESMA guidelines are first and foremost about minimum standards of knowledge and competence that apply to anyone providing advice to clients. In this respect, the SMSG is in favour of broad based minimum standards.

While the draft guidelines leave it to the NCA's to determine how exactly appropriate knowledge and experience should be assessed, some examples are being given. The SMSG suggests that more prominence be given to the possibility of dedicated courses followed by some kind of certification. With regard to "appropriate experience" it suggests 'close supervision' rather than the requirement of a senior being present at all times during client meetings. However, at the same time, the SMSG insists that the guidelines not only refer to time and resources being made available to the trainee, but also to the one doing the coaching. With regard to the minimum period before someone can be considered to possess appropriate experience, the SMSG acknowledges that this may depend on the intensity of the training as well as on the person concerned. For all these reasons, it suggests that, beyond a regulatory minimum period (e.g. 12 months, as a period which is neither excessively long, nor too short), it should to a large extent be left to the investment firm to determine the appropriate period, assuming that the investment firm remains ultimately liable.

With regard to the grandfathering proposal for employees that provide the relevant services at the date of application, the SMSG believes that the criterion for the grandfathering should not so much be a certain time span of prior experience as in the ESMA proposal (5 years), but rather the principle that the grandfathering is only valid as long as the employee remains with the present employer and to the extent that the employer is ultimately liable and responsible. Also, the SMSG points at the usefulness

that incentives are put in place for those enjoying the grandfathering clause to undergo the assessment anyway. These incentives could be provided by practical arrangements (for example: time and place of training and knowledge assessments) and by promoting the benefits of certification, for example in changing employer. Also, the SMSG insists that the grandfathering arrangement, being a one-off arrangement, does not absolve the financial institution from the obligation to provide training to and assess on an ongoing basis the knowledge and competence of its staff, including those that enjoy the grandfathering.

With regard to the proposed knowledge requirements, the SMSG is of the opinion that the difference between providing advice and providing information is rather a theoretical one, which in practice will be difficult to assess. It also suggests that more prominence be given to the ability to assess the client's risk profile and other relevant client characteristics. In addition, the SMSG suggests that the general principles of back-office operations, to the extent that these are relevant to the client, are included among the knowledge criteria, as well as the ability to understand the difference between past and future performance as well as the limits of predictability.

Although possibilities of cost-effective training can be envisaged, the SMSG is aware that there are costs attached to training and coaching. However, it believes that the cost of conduct risk could potentially by far outweigh the cost of training. It also wants to point at the benefits of a well-trained and competent staff, which could be a competitive advantage.

II. Introduction

1. This advice is written in reply to the Consultation Paper ESMA/2015/753 of 23 April 2015, on draft guidelines for the assessment of knowledge and competence in the context of MiFID II. The Consultation Paper itself follows from MiFID articles 25(1) and 25(9).
"1. Member States shall require investment firms to ensure and demonstrate to competent authorities on request that natural persons giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the investment firm possess the necessary knowledge and competence to fulfil their obligations under Article 24 and this Article. Member States shall publish the criteria to be used for assessing such knowledge and competence.
9. ESMA shall adopt by 3 January 2016 guidelines specifying criteria for the assessment of knowledge and competence required under paragraph 1."
2. The Consultation Paper proposes six questions. However, the SMSG does not consider itself to be confined to these six questions only. Some of its comments go beyond these questions.
3. In particular, the SMSG wants to reiterate some of its earlier advices which touched upon knowledge and competence. These referred to the assessment of knowledge and competence and corresponding certifications; the need for training and support; and the usefulness of a dialogue with employee representatives, where available, on the needs for training and sales policy in general. The SMSG believes that these three elements can further reinforce one another.
 - On assessment of knowledge and certification, see the SMSG advice on MiFID II (2014/SMSG/35, dated 03/09/2014), point 15:

“15. The SMSG considers such requirement for anyone advising or selling financial products to take a series 7 type exam as exist in the US or in France to be positive. It should even be mandatory across the EU. “

- On training, see the SMSG advice on MiFID II (2014/SMSG/35, dated 03/09/2014), points 39 -41.

“39. There is a need for both broad-based training in order to establish a culture of awareness regarding MiFID requirements and the importance of compliance. Training should be compulsory for concerned employees who sell any financial product on an annual basis. It also needs to be ensured that the training is of good quality. This ensures that questions can be asked directly, which is important especially for new employees.

40. The knowledge needs to be verified on a regular basis and if the required level of knowledge is not attained in a first instance, there should be no sanctions but rather a re-training by someone.

41. There is also a question of resources to be able to effectively make use of the training provided. It needs to be ensured that required technical conditions (such as proper IT systems) are made available for employees in order to e.g. give proper advice for the clients.”

- On the usefulness of dialogue, see the SMSG advice on cross-selling (2015/SMSG/016, dated 27/03/2015).

“In this respect, the SMSG believes that proper sales policies, including training, remuneration and sanctions should ideally be part of a dialogue with employee representatives where available.”

4. Due to the differences among EU member states when it comes to structure, size, maturity, sophistication etc. of the markets and hence also training systems plus the internationalisation and increasing movement among people it is important that these Guidelines are principle-based rather than overly prescriptive. Notwithstanding this consideration, the SMSG believes that the guidelines should be subject to ongoing supervisory convergence and peer review, as this could facilitate best practices and mutual recognition. Apart from the obligation for NCA's to publish their criteria for knowledge and competence assessment, the SMSG proposes that ESMA establishes a database containing the criteria of the different member-states. The motive behind this call for supervisory convergence, peer review and transparency on the criteria is that the SMSG considers it important that passporting does not result in watering down of knowledge and competence criteria.
5. The Consultation Paper refers at several instances to proportionality. The SMSG has been informed of several systems where a degree of proportionality has been introduced in national systems of certification and knowledge assessment. This proportionality was to a large extent linked to the type of products offered. In Denmark, the system of certification is linked to a green/yellow/red light classification, which on its turn depends on elements such as risk and complexity. In Sweden too, the trainings and exams are differentiated but starting with and from a common base of minimum standards and then adding elements and questions. While there may be reasons to set higher standards depending on the risks, sophistication and the complexity of the products being advised/sold, the SMSG believes that the ESMA guidelines

are first and foremost about minimum standards of knowledge and competence that apply to anyone providing advice to clients. In this respect, the SMSG is in favour of broad based minimum standards.

6. The draft guidelines relate 'knowledge and competence requirements' to 'appropriate qualification' and 'appropriate experience' (see point 8 of the guidelines). The SMSG has some comments on these concepts:
 - First of all, it believes that knowledge and experience reinforce one another. Experience, expressed as number of years in the job, does not on itself guarantee adequate knowledge. At the same time, formal knowledge needs to be enriched by experience "on the job".
 - With regard to 'appropriate qualification', the draft guidelines leave it to the NCA to determine how these qualifications will have to be assessed, but provides some examples. However, there is no example referring to the possibility of dedicated courses at company level or sectoral level followed by some kind of certification.
 - The first example refers to a primary university degree in economics with specific exams focusing on financial markets being a sufficient condition.
 - The second example refers to other recognised qualifications complemented by identified courses in financial services.
 - In both examples, some kind of prior education is the backbone, 'identified courses in financial services' are at most a complement.
 - While the SMSG believes that specific degrees might facilitate the acquisition of appropriate knowledge, they would very seldom in themselves be a sufficient condition. Neither should they be an absolute prerequisite for 'appropriate qualification', as in this case, not having that specific degree would be a barrier to entry. A teacher, who has the ability to explain things in a way that is understandable to everyone, could, provided that (s)he has acquired some knowledge through focused courses, be adequately qualified to give advice, even without academic degree in economics.
 - As an alternative, the SMSG points at the usefulness of dedicated courses, presented either at company level or at sectoral level in consultation with the regulator and followed by certification. At the very least, we would suggest that an example be added and given prominence: "*an NCA might determine that focused courses, offered at company level or at sectoral level in consultation with the NCA, and followed by a formal test (knowledge assessment)*" should be considered an appropriate qualification'.
 - With regard to 'the notion, of appropriate experience', the draft guidelines relate 'experience' to a minimum period of consecutive work in a relevant position, during which the trainee has to be accompanied by a senior colleague during every meeting with clients.
 - The SMSG suggests replacing the latter requirement by the notion of 'working under close supervision of a senior colleague'. Especially in the early days/stages of employment, there is indeed some merit in the idea of having a senior colleague present during meetings with clients. However, alternative approaches could gradually be considered like gradually loosening the control on the trainee and allowing her/him to do the simpler meetings, preparatory meetings of the trainee and her/his senior, during which the meetings of the day are discussed and prepared, and so on... For all this reasons, we propose the notion of 'close supervision', rather than the requirement of a senior to be present at all times.

- The notion of close supervision being a less strict definition than the requirement for a senior to be present at all times during all meetings with clients, entails the risk that this obligation will be interpreted in a loose way, especially in a context of time pressure. For this reason, the SMSG suggests that the obligation that time and resources be provided for training not only applies to the trainee, but also to the coach. (For example point V.V, 25, f: ensure that, when the staff member is being trained, the person providing the training has the necessary knowledge and competence required by the guidelines and gets sufficient time and resources to do so).
- The guidelines do not specify how long the minimum period should be before a trainee is considered to have ‘appropriate experience’. This is something, which, probably, is more difficult to assess than knowledge. While the SMSG obviously considers ‘experience’ to be highly relevant, it also acknowledges that the effectiveness of a training process may depend to a large degree on the intensity of the training process, the cases handled, and the capabilities of the trainee. Moreover, it is not certain whether the legislator really had the definition of a minimum period in mind, when drafting article 25(9). CRD IV, for example, mentions ‘experience’ (art 91(1)) as a separate word, which is not the case in MiFID II, art 25(9). For all these reasons, the SMSG believes that, beyond a regulatory minimum period after the knowledge assessment has been completed, it should to a large extent be left to the investment firm to determine the appropriate period, assuming that the investment firm remains ultimately liable. As for the regulatory minimum period, it suggests “12 months” as a requirement which is neither excessively long, nor too short.

III. Do you think that not less than five consecutive years of appropriate experience of providing the same relevant services at the date of application of these guidelines would be sufficient to meet the requirement under knowledge and competence, provided that the firm has assessed their knowledge and competence? If yes, please explain what factors should be taken into account and what assessment should be performed by the investment firm. Please also specify whether five consecutive years of experience should be made in the same firm or whether documented experience in more than one firm could be considered (Q1).

7. The SMSG believes that the wording of this paragraph should be made more explicit to make sure that it is interpreted as a one-off grandfathering arrangement for those who are already in function at the entry into force of these guidelines.
8. With regard to the grandfathering, the SMSG proposes the principles:
 - that this grandfathering should remain valid only as long as the employee remains with his present employer;
 - and to the extent that that the employer is fully liable and responsible.
9. The SMSG believes that the principles established above are more important than a discussion on the time-span of experience in the job for people to whom the ‘grandfathering’ should apply. As criterion for ‘time-span on the job for people to whom the grandfathering applies’, it proposes a period of 12 months. This 12 month period is in line with the minimum regulatory experience criterion proposed above. However, the SMSG reiterates that it considers the prin-

ciples proposed above (see 8a and b) to be more relevant than the issue of the time-span as such.

10. Liability and responsibility of the firm also means that grandfathering being a one-off occurrence should not be confused with the need to, on an ongoing basis assess knowledge and competence, as clearly spelled out in the guidelines, 25b
11. The relevance of grandfathering clause evaporates faster over time, not only due to it being a one-off arrangement, but also to the extent that incentives are put in place for those enjoying the grandfathering clause as long as they stay with their current employer, to on a regular basis undergo the formal assessment procedure anyway. This could e.g. be encouraged through:
 - Promoting the benefits of certification: the possibility to change employer while relying on the certification as a reference without having to first pass a test;
 - By practical arrangements facilitating training and knowledge assessments. This refers to time and place of training and knowledge assessments. If, for, example, there is only one possibility a year to undergo training and/or to have one's knowledge assessed, the hurdle is higher than when this is organized on a regular basis.
12. There is a specific situation not covered by the present 'grandfathering' proposal. Some member states have already formal systems of certification and licensing. What with people who have been certified in terms of national systems established prior to 1 January 2017? The SMSG suggests that national certification, in line with the guidelines, is recognized beyond 1 January 2017. However, at the same time, the SMSG calls on National Competent Authorities to compare their existing national arrangements with the new MiFID II standards and update it where needed.

IV. ESMA proposes that the level and intensity of the knowledge and competence requirements should be differentiated between investment advisors and other staff giving information on financial instruments, structured deposits and services to clients, taking into account their specific role and responsibilities. In particular, the level of knowledge and competence expected for those providing advice should be of a higher standard than that those providing information. Do you agree with the proposed approach? (=Q2)

13. **The SMSG is of the opinion that the difference between providing advice and providing information is rather a theoretical one, which in practice will be difficult to assess.** Moreover, there is a risk that investors will be confused. Is the person sitting in front of them merely giving information or providing advice? Note: this remark does not refer to people at the reception desk who merely distribute brochures, leaflets

Are there, in your opinion, other knowledge and competence requirements that need to be covered in Annex IV?

14. The guidelines need to be more explicit about the need also to assess the clients' financial situation, including his/her capacity for investment loss, the clients' investment objectives, including their risk tolerance and clients' knowledge and investment experience. MiFID 2 re-

quires that staff of investment firms facing clients, be competent to fulfill their obligations under Art. 24 & Art. 25 (suitability and appropriateness assessment). This assessment has two sides: one is product knowledge, including costs and risks and the other is knowing the customer. While the draft guidelines cover the main subject areas related to knowing the product, they lack in requirements for knowledge and competence in assessing the client risk profile and other characteristics. However, regulators in major EU markets have found that up to 90 % of assessments of clients' risk tolerance, for example, were invalid and unreliable, which led to unsuitable investment advice, provided to clients [AFM (France - 2010); FSA (UK - 2011); CONSOB (Italy - 2012)]. Hence, we suggest that the guidelines are made more explicit about knowledge and competence requirements relating to both understanding the client's risk profile and providing advice such as: (i) the concept of financial planning; (ii) the process by which appropriate investment advice is given to the consumer; (iii) ethical issues in relation to the conduct of business. In this respect, the SMSG also points at the usefulness of ISO22222: "personal financial planning requirements for personal financial planners".

15. In addition, the SMSG proposes that knowledge of the general principles of back-office operations, to the extent that these are relevant to the client (example: settlement) be included among the knowledge criteria.
16. Also, the SMSG proposes to add: "understand the difference between past performance and future performance scenario's as well as the limits of predictability".
17. In Annex IV, point 21d and point 23d, the SMSG suggests to add a reference to the KID document: "*assess data relevant to the investment products offered or recommended to clients such as **Key Information Document**, a prospectus, financial statements, or financial data.*"
18. The SMSG takes it for granted that product knowledge also includes the ability to explain and understand the difference between single instruments, like shares and bonds, and funds investing in those instruments.

V. What additional costs will firms face as a result of the proposed guidelines?

19. The SMSG is aware that there is a cost attached to training and coaching. However, the SMGS is of the opinion that the cost of improper behaviour and conduct risk (fines, penalties, reputational risk) could potentially outweigh by far the cost of training. In addition, the SMSG also wants to point at the benefits of a well-trained and competent staff. Indeed, a competent staff may be a competitive advantage of a financial institution.
20. The SMSG suggests that cost-effective ways of training be considered. Training which has been jointly established through e.g. sectoral arrangements, possibly in cooperation with the regulator, could possibly result in economies of scale that could reduce the burden for smaller firms. Also, digital training, be it balanced with traditional training, could contribute to reduce costs.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 8 July 2015

A handwritten signature in blue ink, consisting of several overlapping loops and a long horizontal stroke extending to the right.

Jesper Lau Hansen
Chair
Securities and Markets Stakeholder Group