Eurosif response to the ESMA consultation on draft guidelines regarding certain aspects of the MiFiD II suitability requirements

Eurosif is the leading pan-European association promoting sustainable finance at European level - encompassing the European Union (EU), the wider European Economic Area (EEA) and the United Kingdom (UK). In addition, Eurosif supports initiatives at global level to promote an ambitious agenda for sustainable finance. Eurosif is a partnership comprised of Europe-based national Sustainable Investment Fora (SIFs). Each of the SIFs has a broad and diverse membership including asset managers, institutional investors, index providers and ESG research & analytics providers with aggregate assets under management (AuM) amounting to over EUR 20 trillion. Eurosif's activities involve contributing substantively to public policy and conducting research that enables a better understanding of ESG and SRI markets and the obstacles encountered by sustainability-oriented investors.

Eurosif and its members are committed to the growth and development of sustainable finance and support the ambition of global and European policymakers in enabling a fully transparent and reliable sustainable investment market through appropriate and well-designed regulation and industry practice.

Eurosif appreciates the opportunity to respond to ESMA's consultation on the draft Guidelines on certain aspects of the MiFID II suitability requirements. As outlined in the Consultation Paper, the assessment of suitability is one of the most important elements for investor protection in the MiFID II framework. Eurosif fully supports the need to integrate consideration of client sustainability preferences into the existing suitability assessments, especially in light of the increased demand for, and marketing of sustainable investment products. Eurosif strongly encourages any efforts to increase the supply of sustainable investment products, and to drive up the level of ambition when it comes to the integration of sustainability preferences in financial products.

However, Eurosif has reservations over the approach to gathering client sustainability preferences envisaged by the updated Guidelines (particularly in Guideline 2). Eurosif recognises that the updated Guidelines reflect the legislative text of the Delegated Act. Nevertheless, we consider the provisions on the integration of client sustainability preferences in the Level 2 of MiFID II to be suboptimal in their design, difficult to apply in practice, and likely to lead to a severe mismatch between client expectations and available, financially suitable instruments and investment products. In particular, the element of 'self-assessment' introduced into the suitability assessment with regard to sustainability preferences carries significant risks. Such an approach is likely to detach consideration of client sustainability preferences from the assessment of financially suitable products and lead to practices in which the client must 'adapt' their sustainability preferences.

Clear guidance is needed to enable financial advisers to fulfil their role vis-à-vis the client, by promoting financial instruments and products with features that best correspond to client sustainability preferences while also being financially suitable. It should be incumbent on financial advisers to assess the suitability of financial instruments and products for their clients in a process that integrates both consideration of the client's financial profile and their sustainability preferences.

The current provisions of MiFID II envisage a scenario in which the client's sustainability preferences are based on 'self-assessment' and must be expressed in abstract, technical language derived from EU legal texts. In our view, this effectively disassociates the process for determining client sustainability preferences from the financial suitability assessment rendering it challenging for advisers to ensure that the outcomes of these two distinct processes will be reconcilable.

As an alternative approach, we believe that the client should be able to express their sustainability preferences in general terms rather than in the technical language prescribed by Art. 2(7) points (a), (b) & (c). The financial adviser should then interpret and 'translate' the sustainability preferences of the client into product features corresponding to points (a), (b) and points (a), (b) & (c) or a combination thereof. One or more financially suitable products possessing those features, and thus best matching the sustainability preferences of the client, should then be selected and offered to the client. We elaborate further on this alternative approach in our responses to the various questions in the consultation.

Finally, satisfying client sustainability preferences in the manner prescribed by MiFID II will depend on the availability, accuracy and reliability of data and the comparability of products possessing different sustainability features (level of Taxonomy-alignment, share of 'sustainable investments' and PAIs). The persistent issue of limited data availability and reliability will render operationalising the MiFID II requirements extremely challenging for firms.

GUIDELINE 1 – INFORMATION TO CLIENTS ABOUT THE PURPOSE OF THE SUITABILITY ASSESSMENT AND ITS SCOPE

Question 1

Do you agree with the suggested approach on the information to clients about the purpose of the suitability assessment and its scope? Please also state the reasons for your answer.

Eurosif answer

Eurosif agrees with ESMA's proposed approach and the new supporting Guideline, as inserted by Paragraph 16 of the updated Guidelines. In particular, we believe that firms should explain the concept of 'sustainability preferences' in simple, **non-technical language** that will enable the client to understand, in broad or general terms, the sustainability-related characteristics/objectives that their investments/product could possess.

Eurosif also considers it essential that firms ensure that clients understand that information on their sustainability preferences is being gathered as part of the suitability assessment, the purpose of which, as per Para. 11 of the Guidelines, is 'to enable the firm to act in the client's best interest'.

Question 2

Do you agree with the new supporting guideline in relation to the information to clients on the concept of sustainability preference or do you believe that the information requirement should be expanded further? Please also state the reasons for your answer.

Eurosif answer

Eurosif endorses the new supporting guideline on the provision of information to clients on the concept of sustainability preferences. In particular, we emphasise the need for the concept of sustainability preferences to be explained to the client in a 'clear manner' that avoids technical language.

At this point in the advisory process, the client should receive a general explanation of what sustainability characteristics financial instruments or products can possess. This should include an explanation of sustainability risks and the impact or potential outcomes that the client's investments may imply depending on their sustainability characteristics. The firm should inform the client that some financial instruments can manage sustainability risks whereas others may have exposure to economic activities or companies that have a stronger performance from a sustainability perspective (through, for example, investment in Taxonomy-aligned activities).

The use of abstract or technical terms derived from legal texts – namely; 'Taxonomy-aligned activities', 'sustainable investment' as defined by Art. 2(17) of SFDR, and 'Principal Adverse Impacts' should be avoided by firms.

The information pertaining to sustainability preferences will be provided to clients following the explanation by the firm that the principal purpose of the suitability assessment is to determine what investments are financially appropriate for the client. Accordingly, the firm should be explicit that the reason for discussing sustainability preferences is to identify what the client is seeking to achieve in addition to their financial goals.

GUIDELINE 2 – ARRANGEMENTS NECESSARY TO UNDERSTAND CLIENTS

Question 3

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 of the clients' sustainability preferences? Please also state the reasons for your answer.

Are there other alternative approaches, beyond the one suggested in guideline 2, that you consider compliant with the MiFID II requirements and that ESMA should consider? Please provide examples and details.

Eurosif answer

Eurosif anticipates significant challenges to the workability of the approach to understanding clients sustainability preferences proposed in Guideline 2. Moreover, elements of the update to Guideline 1 do not appear to be compatible, nor coherent, with the updates to Guideline 2.

Firstly, as a general point, the Guidelines envisage a scenario in which the discussion of sustainability preferences is effectively detached from the assessment of financial suitability that precedes it. In the consultation paper, ESMA acknowledges the reversal of the 'traditional' parameters of the suitability assessment when it comes to sustainability preferences, which will be determined by the client following instruction from the adviser as to how to express sustainability preferences in terms prescribed by Art. 2(7), points (a), (b), and (c). In our view, the Guidelines should instead envisage a scenario in which client sustainability preferences are assessed by the adviser, after an exchange in which the client has expressed their preferences in general terms, and following the assessment of financial suitability.

Secondly, Para. 25 is highly prescriptive and effectively compels firms to gather extremely granular information on the client sustainability preferences; which the client must articulate in abstract, technical terms derived from EU legal texts. This approach does not appear reconcilable with the need to explain the concept of sustainability preferences in a clear, non-technical manner. Moreover, the granular approach proposed by Para. 25 would be challenging to operationalise. Collecting data on all elements of sustainability preferences outlined in Art. 2(17) points (a), (b), and (c) would be resource intensive and time consuming and would result in either highly specific or excessively granular sustainability preferences, assuming the client had correctly grasped the abstract concepts and technical language in which sustainability preferences are to be expressed.

Thirdly, it is highly improbable that an average retail investor will have a view on all of the PAIs and be able to express a preference in relation to specific PAIs in qualitative and/or quantitative terms.

As stated in our introduction, firms should provide clients with an explanation of sustainability preferences that enables the latter to express them in broad or general terms – indicating to the firm what the client considers most important in terms of sustainability-related features of the investment/product. It should then be incumbent on the firm to identify sustainability features of investments/products corresponding to Art. 2(7) points (a), (b), and (c) that best capture or reflect the client's sustainability preferences. The firm should then identify which of the available financially suitable instruments best matches the sustainability preferences of the client. This approach would ensure the integration of sustainability preferences remains compatible with the spirit of the suitability assessment. It would also mitigate the risks inherent to self-assessment.

With respect to Para. 26 of the updated Guideline 2, Eurosif would be supportive of a number of the proposed steps envisaged by ESMA. For example, we would be supportive of the first and second steps outlined.

In the case of the third step, we do not consider soliciting clients to set a 'minimum proportion' for Taxonomy-aligned investments or sustainable investments would be a workable approach. Instead, we believe that only in cases where the firm has assessed investment in Taxonomy-aligned activities or 'sustainable investments' as defined by Art. 2(17) as reflecting the client's sustainability preferences should select the financially suitable instruments with the highest level of Taxonomy-alignment and/or proportion of sustainable investments to offer to the client.

However, in relation to PAI indicators, we are supportive of the proposal to consider groups or 'families' of PAI indicators based on the clients focus on certain environmental, social and/or governance issues. Firms could identify the sustainability themes that matter most to the client, identify the material PAI indicators (whether they relate to climate, biodiversity, water use, social, etc.), and recommend instruments/products that best integrate said PAI indicators.

Throughout the process, the adviser should exercise discretion when it comes to assessing what PAI indicators are most relevant to the client. Initiating a qualitative evaluation to determine which PAI indicators or category thereof are key to the client, while desirable, would be challenging given the average level of knowledge of retail investors and advisers.

Finally, we are uncomfortable with the proposed approach to situations in which the client indicates that they have sustainability preferences but do not clearly articulate what those preferences are in the terms prescribed by Art. 2(7) points (a), (b) and (c). There is a distinct possibility that this situation may become the 'default' scenario given the level of detail the client is expected to provide under the proposed 'self-assessment' approach.

In situations where the client has not been able to articulate clear sustainability preferences using the rather technical terminology prescribed by Art. 2(7), set minimum proportions or provide qualitative and quantitative information on PAI indicators, the level of sustainability ambition is left at the sole discretion of firms. Bearing in mind the possibility for conflicts of interest to exist, this would be an unsatisfactory outcome. As an alternative approach, we would suggest that the firm is required to identify through questions/dialogue the objectives of the sustainability preferences of the client, match these with the pertinent preferences options and, then, selecting from the financially suitable products the ones performing best on these KPIs.

Question 4

Do you believe that further guidance is needed to clarify how firms should assess clients' sustainability preferences?

Eurosif answer

Eurosif believes that the Guidelines should enshrine a general principle or requirement that firms are responsible for translating the client's sustainability preferences into sustainability features corresponding to Art. 2(7) points (a), (b) and (c) in a transparent, neutral and traceable way.

Question 5

Where clients have expressed preference for more than one of the three categories of products referred to in letters a), b) or c) of the definition of Article 2(7) of the MiFID II Delegated Regulation, do you think that the Guidelines should provide additional guidance about what is precisely expected from advisors when investigating and prioritizing these simultaneous / overlapping preferences?

Eurosif answer

Eurosif believes that the onus should be on firms and advisers to interpret the sustainability preferences of clients, as expressed in broad or general terms, and identify financially suitable products with sustainability features, as prescribed by Art. 2(7), that best correspond to the client's sustainability preferences.

We can anticipate scenarios in which the client considers a range of sustainability issues to be important. The firm may be able to offer financially suitable products that possess sustainability features addressing one or more of these sustainability issues to varying degrees. It should be left to the discretion of the firm and client to determine which of these products is most satisfactory to the client.

Requiring the client to provide extremely granular information on their sustainability preferences, including 'minimum proportions' for the level of Taxonomy-alignment, share of 'sustainable investments' and an assortment of PAIs, will lead to an outcome in which each client has highly specific sustainability preferences that will be difficult to fully satisfy with existing or future product offerings.

Question 6

Do you agree with the proposed approach with regard to the assessment of ESG preferences in the case of portfolio approach?

Are there alternative approaches that ESMA should consider? Please provide possible examples.

Eurosif answer

Eurosif agrees with the proposed approach with regard to the assessment of ESG preferences in the case of portfolio management bearing in mind our response to Q3.

GUIDELINE 5 – UPDATING CLIENT INFORMATION

Question 7

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

Eurosif answer

Eurosif agrees with ESMA's proposed approach to updating client information.

GUIDELINE 7 – ARRANGEMENTS NECESSARY TO UNDERSTAND INVESTMENT PRODUCTS

Question 8

Do you agree with the suggested approach with regards to the arrangements necessary to understand investment products? Please also state the reasons for your answer.

Eurosif answer

Eurosif agrees with ESMA suggested approach in Guideline 7.

Question 9

Do you believe that further guidance is needed to clarify how firms should take into consideration the investment products' sustainability factors as part of their policies and procedures? Please also state the reason for your answer.

Eurosif answer

Eurosif does not believe that further guidance on this aspect is needed.

GUIDELINE 8 – ARRANGEMENTS NECESSARY TO ENSURE THE SUITABILITY OF AN INVESTMENT

Question 10

Do you agree with the additional guidance provided regarding the arrangements necessary to ensure the suitability of an investment concerning the client's sustainability preferences? Please also state the reasons for your answer.

Eurosif answer

Eurosif fully endorses ESMA's proposal that a suitability assessment with respect to clients' sustainability preferences should follow the carrying out of a financial suitability assessment. Therefore, we are fully supportive of para. 79 as proposed by ESMA That said, firms should be able to add the new requirements to consider sustainability preferences as an extension onto their existing, often already standardised, procedure for carrying out a financial suitability assessment, rather than having to fully re-organise the procedure for the latter. This will minimise the additional costs of overhauling systems to comply with the MiFID II requirements.

Question 11

Do you agree with the approach outlined with regards to the situation where the firm can recommend a product that does not meet the client's preferences once the client has adapted such preferences?

Do you believe that the guideline should be more detailed? Please also state the reasons for your answer.

Eurosif answer

Eurosif has significant misgivings regarding the approach outlined by ESMA. According to our interpretation, Para. 80 presupposes that the sustainability preferences of clients will be identified in a process total separate and distinct from the assessment of financial suitability (despite occurring nominally as part of the suitability assessment).

Pursuant to Guideline 2, the client will be expected to express, in abstract terms, their sustainability preferences from amongst one or more of the MiFID II criteria prescribed by Art. 2(7) points (a), (b), and/or (c). As stated earlier in our response, if the assessment of sustainability preferences is done in such an abstract way and is thus detached from the financial suitability assessment, there is a real risk that a gap will emerge between the expectations of the client and the availability of products. Eurosif does not believe that this will increase the attractiveness of investing in investment products overall, nor specifically in sustainable investment funds.

If ESMA remains committed to the original proposal on this point, we agree that advising or selling products with sustainability features inferior to the initial sustainability preferences of a client can only occur once the client has lowered their preferences and the process is well documented.

Question 12

Do you agree with the approach outlined with regards to the situation where the client makes use of the possibility to adapt the sustainability preferences? Please also state the reasons for your answer.

Eurosif answer

Assuming ESMA remains committed to its original proposal, whereby the sustainability preferences of clients will be identified in a process totally separated from the assessment of financial suitability, we would support the approach envisaged in Para. 80 and 81.

However, we would suggest adding a further safeguard. If a client revises their sustainability preferences downwards to match with available instruments, the firm would be required to keep in the record evidence of the initial level of ambition.

When the suitability assessment is updated, possibly as part of an ongoing relationship, the firm should be required to reevaluate whether, since the previous assessment, instruments have since become available that meet the higher, initial level of sustainability preferences. This would ensure that clients can fully benefit from the progress and innovation that is expected to occur as sustainable investing increases in popularity.

If this involves the client changing instruments, the firm should act in line with Guideline 10 and the new para. 97.

Question 13

Could you share views on operational approaches a firm could use when it does not have any financial instruments included in its product range that would meet the client's sustainability preferences (i.e. for the adaptation of client's preferences with respect to the suitability assessment in question/to the particular transaction and to inform the client of such situation in the suitability report)?

Eurosif answer

No response

Question 14

Do you agree with the proposed approach for firms to be adopted in the case where a client does not express sustainability preferences, or do you believe that the supporting guideline should be more prescriptive? Please also state the reasons for your answer.

Eurosif answer

Given the likelihood that some clients may not express any sustainability preferences, Eurosif fully agrees with ESMA's proposed approach in para. 83. Eurosif does not see a need to make the respective supporting guideline any more prescriptive. With the mainstreaming of sustainable finance and many firms launching or requalifying instruments (investment funds) as promoting environment or social characteristics (Article 8 SFDR) or pursuing a sustainable investment objective (Article 9 SFDR), it is advisable that firms could orient clients with no sustainability preferences towards products that have sustainability integrated in their investment process to varying degrees, provided these instruments meet the financial suitability requirements.

Question 15

Do you agree with the proposed approach with regard to the possibility for clients to adapt their sustainability preferences in the case of portfolio approach?

Do you envisage any other feasible alternative approaches? Please provide some possible examples.

Eurosif answer

Eurosif agrees with ESMA's proposed approach.

Question 16

What measures do you believe that firms should implement to monitor situations where there is a significant occurrence of clients adapting their sustainability preferences?

What type of initiatives do you envisage could be undertaken to address any issues detected as a result of this monitoring activity?

Eurosif answer

This depends on whether the approach to determining client sustainability preferences will be kept effectively separate from the assessment of financial suitability, and defined by the client in abstract terms, as is currently envisaged by Guideline 2.

As outlined earlier in our response, Eurosif would favour an approach that better integrates the financial and sustainability dimensions of the suitability assessment. The approach proposed in Guideline 2 makes the determination of sustainability preferences a matter of 'self-assessment' on the part of the client. Such an approach would only be nominally part of the suitability assessment.

If kept separate, we are likely to see a gap between the expectations of clients with strong sustainability preferences; determining a high minimum share of (a) Taxonomy-alignment and/or (b) 'sustainable investments' compared to the reality of many products. Available, financial suitable products are likely to have a much lower initial proportion of Taxonomy-alignment and/or 'sustainable investments'. These lower initial proportions will largely reflect the environmental reality of investment opportunities.

Firstly, from a macro perspective, the global economy is only marginally aligned with the Taxonomy and not on track to meet 2050 climate objectives. This results in limited investment opportunities that are Taxonomy-aligned.

Secondly, by design, the Taxonomy only covers certain economic sectors (those with the greatest potential to contribute substantially to environmental objectives) and not others. As a result, large segments of the investible universe are not assessed by the Taxonomy and thus ineligible for Taxonomy-alignment.

Thirdly, from an operational standpoint, data reliability in terms of Taxonomy-alignment calculations remains a fundamental challenge. In response to this, a significant number of firms have been understating the Taxonomy-alignment of their products to avoid overpromising or misleading clients.

Due to these factors, we anticipate that initial sustainability preferences will often have to be readjusted to reflect less ambition. This will not necessarily be attributable to an unwillingness of firms to offer more ambitious products but merely an expression of broader, structural market issues.

That said, we are supportive of the proposal that firms should monitor the situation where there are frequent and significant occurrences of clients having to 'adapt' their sustainability preferences.

GUIDELINE 10 – COSTS AND BENEFITS OF SWITCHING INVESTMENTS

Question 17

Do you agree with the proposed amendment to supporting guideline 10? Please also state the reasons for your answer.

Eurosif answer

Eurosif agrees in principle with ESMA's proposed approach that when providing investment advice, a clear explanation of whether the benefits of the recommended switch are greater than its costs should be included in the suitability report the firm has to provide to the retail client before the transaction is made. This is all the more important in the context of a switch requested by the client on the basis of their sustainability preferences no longer being satisfied by their investments. In such instances, the benefits of having a more sustainable investment product may imply higher costs and a different risk-return profile, which in turn could lead to a product no longer being *financially* suitable.

GUIDELINE 11 – QUALIFICATIONS OF FIRM STAFF

Question 18

Do you agree with the additional guidance regarding to the qualification of firms' staff or do you believe that further guidance on this aspect should be needed? Please also state the reasons for your answer.

Eurosif answer

Eurosif strongly supports ESMA's proposal as concerns the need for appropriate trainings for staff. As is evident, understanding and explaining the different terms used in the EU's sustainable finance rulebooks, and particularly explaining the definitions under Art. 2(7) MiFID II DR requires extensive knowledge and competence on the part of the advisor. This is particularly true in cases where advisors are required to explain these terms in simple, non-technical language. Consequently, Eurosif sees a strong need for additional guidance and specific training material for advisors, which focusses on how advisors can translate the very technical terms of the definitions under Art. 2(7) MiFID II DR into non-technical language.

That said, Eurosif would like to emphasise that any training on carrying out a MiFID II suitability assessment which includes the consideration of clients' sustainability preferences, should only be provided to the advisors who carry out such assessment. It would be unrealistic and too burdensome in terms of capacities and budgets to train all informing staff members on this. Rather, it would be advisable to include general sustainability- and ESG-related topics in the general training of the entire staff.

GUIDELINE 12 – RECORD-KEEPING

Question 19

Do you agree on the guidance provided on record keeping? Please also state the reasons for your answer.

Eurosif answer

Eurosif fully agrees with ESMA's proposed approach of requiring a firm to record all relevant information about the suitability assessment.

PLANNED ALIGNMENT WITH ESMA GUIDELINES ON APPROPRIATENESS AND EXECUTION ONLY

Question 20

Do you agree on the alignment of the two sets of guidelines (where common provisions exist for the assessment of suitability and appropriateness)? Please also state the reasons for your answer.

Eurosif answer

No response

Question 21

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

Eurosif answer

No response

ANNEX – GOOD AND BAD PRACTICES

Question 22

Do you have any comment on the list of good and poor practices annexed to the guidelines?

Eurosif answer

No response

Question 23

What level of resources (financial and other) would be required to implement and comply with the guidelines (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.

Eurosif answer

No response