EFAMA

European Fund and Asset Management Association

CONSULTATION RESPONSE

Brussels, 26 April 2022

EFAMA RESPONSE TO ESMA'S CONSULTATION PAPER "GUIDELINES ON CERTAIN ASPECTS OF THE MiFID II SUITABILITY REQUIREMENTS" (ESMA35-43-2998)

EXECUTIVE SUMMARY

EFAMA places huge importance on this revision of ESMA's suitability guidelines, as they spell out in detail how investors can invest in sustainable investment products. If they are well designed, the guidelines have the potential to significantly boost capital flows towards sustainable investments; a goal that the European fund industry strongly supports. On the contrary, if they were poorly developed, the guidelines may lead to an additional, lengthy tick-the-box exercise (on top of an already extensive suitability process) which could result in no sustainable investment products being ultimately recommended, as they do not fully match all of the client's request.

When the European Commission published the revision to the MiFID II Delegated Regulation, it emphasised that the introduction of sustainability preferences into the advice process is meant to start a **dialogue with investors on sustainable finance**. Unfortunately, we doubt the current ESMA draft guidelines provide enough flexibility for this crucial back-and-forth conversation between investment firms and investors, as ESMA states that "adapt[ing] the sustainability preferences […] should not be the standard procedure". When the revision enters into force on 02 August, however, there will be a stark mismatch between high clients' expectations regarding sustainable finance and the availability of such products. This situation will gradually improve over time when more sustainable finance products will come to the market. However, in the early days, it will be commonplace that no sustainable finance products will fully match a client's originally stated preferences. **More flexibility should therefore be introduced** in the final ESMA guidelines ensuring that investment firms can use **"plain language"** when discussing sustainable finance (rather than the legal concepts) and are allowed to explain why certain expectations cannot be met and **suggest "best matching" alternatives** instead. This will ensure that clients can make an informed investment decision. This additional flexibility can be achieved in various ways, as detailed in our response to Q3. Our proposals aim at ensuring that product manufacturers are incentivised to continuously their range of products "aligned" with the EU sustainable finance framework while avoiding that investors be forced to wait until the "perfect" product is available before starting to invest in sustainable finance.

We believe that further flexibility in other areas will also substantially improve the final guidelines:

1) While generally aimed at retail investors, the final guidelines should **more thoroughly distinguish between retail and professional investors**. While retail investors will need more advice and

explanations, professional investors typically have sufficient knowledge and experience regarding sustainable investments, thus shortening the suitability processes considerably.

2) More emphasis should be put on the outcome of the client exploration process rather than the questions and their sequencing. While the draft guidelines are helpful in sometimes providing examples, it should be clear that the final guidelines are **outcome and not processed-focused**.

3) While acknowledging that this is not under the sole control of ESMA, the **misaligned timing** of the different pieces of the EU's sustainable finance framework has been most unhelpful to the financial industry in implementing the new requirements. We understand that ESMA will not publish the final guidelines before 02 August 2022. Ideally, they would have been made available sufficiently in advance to ensure that investment firms are given enough time to implement the detailed rules.

4) Lastly, relevant data from SFDR, Taxonomy and upcoming CSRD will only become available throughout 2023 and 2025, while product manufacturers already required to advise on these products (and product features) from 02 August 2022. In addition, the complementing revision of ESMA's "product governance" guidelines, defining the ESG target market data, is still missing, even though advisers build their suitability assessments on this data being provided by product manufacturers. While the fund industry (and other market participants) is doing its best efforts to work with these issues, we advocate for a **pragmatic approach to supervisory enforcement of compliance**, granting sufficient time (of at least one year) for the new requirements to be properly incorporated.

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

Q1. 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.

We, generally, agree with the purpose of the suitability assessment and its scope. If the guidelines are implemented correctly and provide investment firms with the necessary flexibility in addressing individual clients' needs while adapting to their specific levels of knowledge, they will significantly contribute to the much-needed increase of capital flows towards sustainable investments. However, pragmatic solutions are key to their success. With this in mind, we have some important observations on the approach of the revised guidelines in relation to sustainability preferences.

Q2. 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.

We appreciate ESMA's approach to explaining the three concepts in non-technical terms. This approach is extremely relevant for retail investors with little to no knowledge and experience in sustainable investing. Other types of investors, especially more sophisticated retail investors (such as HNWIs) and professional investors may already possess sufficient knowledge and experience of these concepts. We acknowledge that paragraph 3 of the draft guidelines already links to Art. 54(3) of MiFID II Delegated Regulation which assumes that professional investors may already possess more knowledge about sustainable finance than retail investors. However, further explicit references for such a proportional approach for professional investors may be needed throughout the guidelines (such as supporting guideline 16, see below).

This differentiation between retail and professional investors should provide investment firms with the much-needed flexibility to phrase the explanation as it fits their respective client bases and in a way that is consistent with how they communicate with these clients. We understand that while the revised Delegated Regulation requires firms to explain to clients the distinction between the different options of sustainability preferences (see Recital 6), this explanation is not limited to the definition of sustainable investments and principal adverse impacts as outlined in SFDR. Rather, to achieve such an understanding, clients will most likely need an explanation going beyond the strictly legal words used in SFDR.

Further, the last sentence of para. 16 of the supporting guidelines stating that "[f]irms should also explain what environmental, social and governance aspects mean" may need further clarification. The current wording suggests that an explanation of "environmental, social and governance aspects" may need to be performed separately from the discussions around an investor's sustainability preferences. We stress that those explanations are, most likely, already part of the client's exploration phase. If this is the case, we believe that they should not have to be repeated. Furthermore, professional investors may not require this type of explanation, as they already have a good understanding of environmental, social and governance aspects.

Mindful of the above and not to overburden (in particular retail) investors with legal concepts, we would suggest the following clarification to the last sentence of the supporting guidelines 16: *Where relevant and depending on the knowledge and experience of the client, firms may also wish to explain what environmental, social and governance aspects as part of the discussions around sustainability preferences or may take place in addition to these discussions.*

In addition, we believe that the guidelines should focus on the outcome of the exploration process (that is, understanding individual preferences) rather than on the process itself (i.e., what questions to ask and/or in which order). In other words, we appreciate ESMA's examples in paragraphs 25 and 26 of the supporting guidelines. However, further flexibility is necessary to ensure that the firms advising end clients have the necessary information about their clients' sustainability preferences rather than prescribing the sequence (particularly if the questions that will be prescribed to be used are closed-ended). While ESMA prefaces paragraph 26 with "could", we believe that the sequence rather than the elements described by ESMA would be detrimental to the client's understanding of the advisory process. We, therefore, believe that paragraph 26 should focus more on the elements of the process rather than its sequencing.

GUIDELINE 2: ARRANGEMENTS NECESSARY TO UNDERSTAND CLIENTS

Q3. 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.

We are uncertain whether ESMA's current approach toward sustainable preferences reaches the intended objective of channelling more capital towards sustainable investment. To explain, it is important to take a step back and consider the foundations of the current suitability concept. It is, therefore, crucial to read our response in conjunction with our response to Q11 (i.e. Guideline 8 on ensuring the suitability of an investment).

The current (i.e. “traditional”) suitability concept relies on two main elements: (1) the “client exploration” phase which aims at obtaining the necessary client information through open and unbiased questions and (2) the “product matching” phase which ends in a recommendation of suitable products in line with the client’s stated situation and preferences. The crucial underlying assumption after these two phases is that there will ultimately be financial products that will ***fully*** match a client’s specific preferences and can be recommended.

However, when the revised MiFID II Delegated Regulation will enter into force on 02 August 2022, this assumption (i.e. that a sufficient number of sustainable investment products will be available to fully match the client’s sustainability preferences) will not hold for a number of interconnected and important reasons mainly due to the nascent nature of the EU sustainable finance framework:

- *Lack of market readiness due to missing underlying data*: Certain important aspects of the “sustainability preferences” framework rely on data that is not yet available on 02 August 2022 and will only start becoming available from 2023 onwards. The progressive extension of scope in the taxonomy, coupled with the lack of reliable quantitative NFRD (and upcoming CSRD) data in the intervening years must be carefully considered when discussing sustainability with clients. In order to avoid misselling, product providers will especially need to act with caution when disclosing certain rates (e.g. taxonomy-alignment). Even if financial products have been designed with these sustainability features in mind, the clear lack of verifiable data (according to the nascent EU framework) will result in very low alignment rates or even 0% alignment in particular regarding the EU Taxonomy being disclosed for many products until this data gap is filled.

- Several important *legal elements are not yet finalised*, making it harder for investment firms to explain them correctly to clients while, at the same time, having to enquire whether they have an interest in these concepts or not.

- The *currently incomplete EU sustainable finance framework* reduces the products available, as the first legislative steps focused on environmental aspects with social/governance matters still to be developed, most likely leading to a focus on environmental products due to this part of its most progressed framework.

- In the beginning, these low-percentage rates stand in stark contrast to *very high clients’ expectations* around sustainable finance. While a client may expect products with a high double-digit taxonomy alignment, these products do not exist. While we cannot provide exact figures at this stage, anecdotal evidence from our members seems to confirm that only a small (i.e. low single-digit) number of funds can provide a taxonomy alignment between 1% to 5% with the vast majority of funds currently declaring a taxonomy alignment of 0%. It is important to note that these 0% figures may even increase after the publication of the recently revised ESAs’ supervisory statement which requires numerical disclosures without the underlying data being available (see first bullet point above).

Until we find ourselves in a situation where there is an ample supply of highly-aligned sustainable investment products (a situation, as we explained, the market is already striving for but will take some years) matching client’s sustainability preferences, it is important to find pragmatic approaches. We fully understand that it is the clear and stated intention of policymakers to use these new rules to push financial product providers to create more “sustainable” products. While we share this ambition (and the fund industry is working hard to match clients’ demand), those products will not become available overnight. In the meantime, investment firms advising end clients must, therefore, be allowed to properly manage clients’ expectations.

When introducing these new sustainability concepts, the European Commission often referred to these changes as “starting a dialogue” between investment firms and investors. This back-and-forth dialogue is crucial to make investors understand what kind of products are currently available on the market. Unfortunately, the draft guidelines currently do not allow for this back-and-forth conversation to take place easily. We must avoid a situation in which investment firms are required to ask multiple and detailed questions about a client’s sustainability preferences with the most realistic outcome being that no product matches a client’s sustainability preferences without the preferences being adjusted. In particular, should no recommendation be allowed at all, this would have a significant impact on retail investments in general and would also not be in line with the legal text (see also answer to Q11). Moreover, it will simply frustrate investors, certainly not promote trust in sustainable products and will lead them to be disengaged with the whole process. For that reason, ESMA’s final guidelines should provide the flexibility and mechanisms that right now are needed to achieve the ultimate goal of financing (the transition to) sustainability.

To ensure that investors participate in the ever-growing sustainable finance market, we, therefore, believe that, for the moment, **one cannot look at the client exploration without any consideration of current market realities. Some additional mechanism(s) must be introduced where the client exploration phase can inform the matching phase, and vice-versa**.

EFAMA members have brought forward different suggestions on how this goal can be met and how the current shortcomings of the draft guidelines can be rectified. The ESMA guidelines could avoid a descriptive approach thereby allowing below solutions or a combination thereof. All proposals have in common the provision of essential flexibility in matching a client’s (theoretical) preferences with the “best matching” products that are offered by the investment firm, while at the same time providing the client with the necessary explanations only “best matching” instead of “fully matching” sustainable investment products are being offered.

- Removal of ESMA’s suggestion that the procedure to adapt a client’s sustainability preferences should not be a “**standard procedure**”. By allowing to make this back-and-forth dialogue a standard procedure, it can be assured that clients will be advised on available products matching (some of or the closest to) their stated preferences. In contradiction to ESMA’s proposal, we would even see a revisiting a client’s sustainability preferences as the essential part of the previously mentioned back-and-forth allowing firms to temper clients’ expectations and allow for a reasonable discussion about what products can realistically be provided. Interestingly, in the portfolio management context, ESMA’s draft guidelines seem to be more flexible, as paragraph 82 suggests how to proceed once “the firm cannot meet [the client’s] preferences”. Similar wording should also be introduced for investment advice.

- Going a step further, the **addition of an intermediate step between the client exploration and matching phases, in which the firm informs the client about currently available products in general terms (i.e. not about products specifically available at the respective firm, is of paramount importance**. First, clients’ preferences are determined through open and unbiased questions. These (original) preferences are stored in the client’s profile. The investment firm is then allowed – based on these original preferences – to inform the client about currently available products. If not adapted, the original preferences are considered and the firm is encouraged to check whether new sustainable investment products are available which are a closer match to the client’s original preferences. E.g. A client’s exploration determines his/her preference for products with 90% (i.e. very high) taxonomy alignment. Current best-in-class products can only offer 5% alignment. The investment firm provides the necessary explanations and gives the client the choice of whether or not he/she will buy this product. At the next regular update, the investment firm considers the client’s

original preferences and informs the client that the current best-in-class taxonomy-aligned products are now at 10%. It then explores whether the client wishes to switch investments.

- Another possibility would be some sort of **“menu” driven approach** (akin to a restaurant’s menu). This approach would be based on a firm’s available sustainable investment products, taking a proportionate approach to ‘granularity’ by using ranges and grouping principal adverse impact indicators (PAIs) by category. In essence, this approach would allow a firm to adapt the client exploration phase in a way that ensures that clients are provided with recommendable sustainable investment products. Through the process, it must be ensured that a client clearly understands that the firm only offers currently available products.

- Another proposal suggests a **“matrix” driven approach**. Firms collect a client’s preferences (along 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) and then present the client with a matrix that identifies available products matching client’s preferences for a or b or c. This matrix shows where the available products match one or more of the client’s stated preferences. Clients will then choose their preferred combinations, where possible. Should no product match any of the three criteria, the matrix would identify the a-b-c features of the available products, so that the clients can adapt their preferences based on available products.

- In combination with the above solutions, there could be some sort of **standardisation of client preferences into standardised categories** (“buckets”), as well as standardising products’ sustainability characteristics to allow matching of both. For example, the ranges for a and b could be categorised under “low”, “medium”, “high” and the lower and upper limits of the ranges would be adapted to the real state of the market, based on benchmarks and discussions between manufacturers and distributors to prevent methodological bias (mostly for “b”). The limits would be adapted gradually at the pace of the progress of the sustainable financial market (e.g. “High” may be over 10% taxonomy alignment currently, but over 40% in 2 years). Initial preferences (L/M/H) could remain unchanged while the sustainability level of the transactions would be upgraded over time.

Last but not least, we advocate for a pragmatic approach to supervisory enforcement of compliance, granting time for the new requirements to bed in, particularly given the existing market reality. We are convinced that percentages of taxonomy compliance and sustainable investments will gradually improve over time, so that clients’ expectations can indeed evolve and, in turn, will have to be followed up by financial advisors.

Q4. Do you believe that further guidance is needed to clarify how firms should assess clients’ sustainability preferences?

For any of the above proposals to work, flexibility rather than further guidance is needed. In that respect, the final guidelines should **provide investment firms more flexibility in how a firm arrives at receiving all the necessary clients’ information**.

This means that questions could be re-arranged or other open-ended questions inserted if that helps accelerate the exploration process (e.g. being allowed to ask the client whether he/she has specific sustainability preferences). We believe that this flexibility is essential to arrive at understanding a client’s sustainability preferences as efficiently and naturally as possible, taking into account the type of client and the range of available products.

In line with the above, we would like to provide some more detailed drafting suggestions:

We object to supporting guideline's paragraph 27 which indicates that "firms should ensure the **same level of granularity** of information is collected on the client's sustainability preferences when providing portfolio management or investment advice with a portfolio approach." Firms should be provided with sufficient flexibility. Although ESMA's draft seems to aim at the type of investment service, this has direct implications for the type of client. In practice, the collection of information is linked to the type of client and/or products being offered. We, therefore, would suggest that final paragraph 27 is better aligned with existing paragraphs 74 and 86 – or even integrated into the latter instead of creating a new paragraph.

Also, the supporting guideline's paragraph 25 requires the information collected to be "**sufficiently granular**" to allow for matching of the client's sustainability preferences. We understand that it aims as requiring firms to collect the necessary information (e.g., which specific sustainability preferences a client has after asking him/her whether he/she has a preference for sustainability) rather than asking too many detailed questions that make it impossible to arrive at an (existing) suitable product or that could possibly pose diversification issues (the more granular the criteria, the less diversified the "matching" products). This consideration is essential and links back to our comments on revisiting a client's sustainability preferences. If too detailed questions are asked and no suitable products are available at the end, it may require more frequent suitability reassessments or client preference adaptations, making this whole process confusing and frustrating for clients. Again, flexibility is key as clients' sustainability preferences will be extremely diverse (in terms of factors to consider and level of ambition). Moreover, it contradicts ESMA's proposal that adaptation of client's sustainability preferences should not be the "standard procedure".

Related to the above point on granularity, paragraph 25's second bullet mentions a "**combination of one or more of the three aspects**". Given the various criteria, there are many combinations, and there are potential diversification issues. Combinations should therefore be part of a dialogue, not a predefined requirement. Also, asking the client on an ex-ante basis about a combination of one or more of the three aspects is not realistic given the limited market in the beginning while adding complexity to the discussion between the client and the firm.

That is why, we believe that, in this context, it is not necessary to explicitly ask a client about their preference for combinations at the beginning of the process. Instead, firms may collect information on aspects a), b) and c) and when presenting possible matching to the clients for a or b or c, combinations are also displayed, and clients can then make their choice for a combination if they wish.

In addition, we note that the first bullet point of paragraph 26 discusses "**sustainability related expectation of the client**". The concept of expectations does not exist in the framework and should be replaced by "preferences".

With regards to **PAI considerations**, we strongly support ESMA's proposed flexibility on grouping PAI indicators as laid out in the fourth bullet point of paragraph 26. Nevertheless, the same bullet point needs to be revised to clarify that the PAI information collected can cover "qualitative OR quantitative elements" rather than "qualitative *AND* quantitative elements" currently mentioned in the draft supporting guidelines in order to align them with the MiFID II Delegated Regulation which talk about "qualitative *OR* quantitative elements" (when defining sustainability preferences).

Also, the last bullet point of paragraph 26 only refers to "client-facing staff" only. It may be useful to also complement this paragraph by considering that these rules should also apply in the case of robo-advice.

In relation to the "**minimum proportion**" for aspects (a) and (b), we support ESMA's suggestion in the third bullet point of supporting guideline 26 to allow for ranges aside from particular percentages. These ranges should, however, not be tied to specific percentages for several important reasons: First, markets will evolve and so will their ranges. While a "high" range may have a very low (e.g., taxonomy-aligned) percentage at the beginning, these figures will eventually increase over time. Thus, especially in these early days, sufficient flexibility must be given to firms to translate these ranges (or particular percentages) to match them with benchmarks or with the range of existing products in the market or offered by the firms. This will allow firms to progressively address the biggest hurdle in introducing sustainability-related aspects into the advice process which currently suffers from a clear mismatch between investors' very high sustainability-related expectations and the products currently available on the market (or those being able to disclose themselves as such at times of insufficient SFDR reporting). In this regard, firms should be given the flexibility to show either the product's commitment or the actual results (assuming a periodic report has already been issued).

To put it into other words and explained extensively in our response to Q3: In any case, it must be guaranteed that a firm can explain to a client that his or her high expectations are matched with those best-matching (such as best-in-class) products currently available on the (fast-evolving) market without this being foul of the guidelines in relation to the approach being neutral and unbiased. This is crucial as specific products and percentages will increase over the coming years. Not allowing for such flexibility, would lead to a very large amount of cases where no products can be offered to the client. We also believe that these considerations are critical for Guideline 8 and would suggest reading our responses to Q10-16 in conjunction with the above.

Q5. 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?

Given the market situation, it should only be an option to ask clients about any preferences of a combination of the category of products. If a client expects a mandatory combination, the investment firm should be allowed to provide further explanations on what types of products are available rather than just noting his/her preference with full knowledge that such products do not exist.

It may also be of importance to know if a client has no expressed preference. In this case, we assume that any three categories of products would be considered as matching the client's preferences.

Q6. 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.

We noted that Q6 talks about "ESG preferences" rather than "sustainability preferences". As the latter is mentioned in the draft guidelines, we assume this to be a small oversight of the question raised and we focus on the issue of "sustainability preferences" in our response.

We generally agree to apply the same approach for client exploration regarding portfolio management or investment advice on a portfolio level, as this is consistent with the existing suitability guidelines.

This being said, we would like to reiterate our general objections to supporting guideline 27 requiring (that "firms should ensure the same level of granularity of information is collected on the client's sustainability preferences when providing portfolio management or investment advice with a portfolio approach") and their missing alignment to the existing paragraphs 74 and 86. As stated in our response to Q4, the granularity of information being collected depends on the type of client and the type of products being offered. Thus, the final guidelines need to provide sufficient flexibility for all client types and products.

Concerning the portfolio management service, it should be noted that the managed portfolios are considered "financial products" under SFDR. Where applicable, the managed portfolio, like any other financial product, must be adjusted to the client's sustainability preferences. In this context, the specific instructions that the client may provide within the framework of the portfolio management service should be assessed according to the client's sustainability preferences and, in any case, would need to be in line with the sustainability configuration adopted by the SFDR managed portfolio.

In line with our previous comments, we also agree that clients should not be pushed in a specific direction. But in practice, clients need to be informed about the type of available suitable products with sustainability factors even if they do not match their specific sustainability preferences. In this regard, please see our extensive comments on Q11.

GUIDELINE 5: UPDATING CLIENT INFORMATION

Q7. Do you agree with the suggested approach on the topic of 'updating client information'? Please also state the reasons for your answer.

Ideally and directly connected to the updating of client information, the final guidelines would have been made available with sufficient time before the entry-into-application of Commission Delegated Regulation to ensure that investment firms are given sufficient time to implement the detailed rules. If this is not possible, we advocate for a pragmatic approach to supervisory enforcement of compliance, granting time for the new requirements to bed.

In relation to portfolio management, enquiring about a client's sustainability preferences for the first time will, in all cases, have some impact on the portfolio characteristics in terms of risks and return (as those considerations were not part of the previous assessments). Consequently, need to liaise with their clients to ensure whether they would indeed accept this impact. If this is not the case, the client may prefer to adapt sustainability preferences which, again, shows that realigning the client's sustainability preferences will be part of a dialogue between the client and investment firm in the short (or even up to a medium) term. As we have noted in our responses to Q3 and Q11, it seems that ESMA's wording of the relevant paragraphs 81 and 82 concerning portfolio management is slightly different than for investment advice, hinting that this dialogue is a necessity.

GUIDELINE 7: ARRANGEMENTS NECESSARY TO UNDERSTAND INVESTMENT PRODUCTS

Q8. 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.

As Guideline 7 refers to "product governance obligations", we would like to take the opportunity to highlight an ongoing misalignment of concepts and terminology between 'sustainability preferences' in the MiFID organisational requirements of the MiFID II Delegated Regulation and 'sustainability-related objectives' within MiFID product governance requirements of the MiFID II Delegated Directive. It is essential to align, as closely as possible, the interpretation of sustainability-related objectives with sustainability preferences as otherwise, manufacturers will be providing information that distributors will not be using in other processes. Whilst sustainability-related objectives could be viewed as having a broader definition, no additional obligations that might have no correspondence on the subsequent process (e.g., suitability assessments) should be imposed.

This being said, we broadly agree with the proposal that investment firms should have procedures and methodologies to consider, and understand, the range of sustainable investment products they are distributing. We also agree that grouping products is a commercially sensible way to do this.

With this in mind, we have a few comments in relation to the draft supporting guidelines:

- Paragraph 70: As laid out in EFAMA's response to the consultation of the recently revised appropriateness and execution-only requirements with ESMA's suggestion to consider "graduating the level of complexity". This is not in line with the legal framework, as MiFID considers financial instruments as either execution-only or not. Each of these distinctions carries its own set of requirements and there is no guidance on what (or who) would consider certain financial instruments as less or more complex (and what this would entail). For this reason, we believe that the last part of paragraph 70 should be deleted.

- We disagree, in part, with ESMA's statement in paragraph 71 that '*Firms are reminded that a grouping of financial instruments for the purpose of the suitability assessment cannot replace the collection of information from clients as described […] above'*. Instead, for the reasons set out above, more flexibility in the suitability assessment should drive the matching process between firms and clients.

- In addition, paragraph 71 also refers to a firm's own "product range" ("their product range"). Since some firms may only advise on third-party products, one may refer to "financial instruments included in the range of products they offer". Likewise, when determining the sustainability factors considered for matching financial instruments with the client's sustainability preferences, entities should be able to take into consideration aspects other than those listed in this supplementary guideline, e.g. the percentage of investments in activities selected in the application of the policies or measures established for the promotion of environmental and/or social characteristics.

Q9. 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.

Please see our response to Q8.

Not directly in response to the question, but we note that paragraph 72 has not been revised but may require an update in relation to sustainability preferences as firms are required to "not solely relying on

one data provider in order to understand and classify investment products but should check and challenge such data or compare data provided by multiple sources of information".

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

Q10. 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.

We agree with ESMA's proposal to sequentially address sustainability preferences once all other criteria have been assessed, but we have serious doubts whether ESMA's approach, regarding the collection of preferences and clients' self-assessment, is in line with (1) the legal texts and (2) is supporting the overall political aim of the changes to MiFID, i.e. providing both the client with a clear view on sustainability but also supporting transformation of Europe's economy into a greener, more resilient and circular system.

First, enquiring clients about the elements of Art. 2(7) of MiFID II Delegated Act for them to carry out the relevant self-assessment is in contradiction with the "traditional" suitability analysis. The fact that MiFID was revised to incorporate sustainability preferences, as a complement to traditional suitability parameters (see Art. 54(5) of MiFID II Delegated Act), does not provide legal support to such contradiction and we see no advantage from an investor protection perspective. On the contrary, it will unhelpfully lead to investor confusion and disengagement on sustainability matters.

Second, ESMA suggests that clients' information requests should not skew clients' sustainability preferences. To provide a very specific example: If firms are expected to openly ask the client (without providing information on available products) how much positive contribution to environmental objectives he/she would like to see in a product, the client will likely answer with a high number such as more than 50%. If firms then afterwards have to explain to the client in detail that such a high number is not available, but rather percentages as high as 2 or 3% should be considered as "best in class" at this point, the client could perceive the whole process as unnecessarily burdensome and lose interest in such types of products altogether.

In line with our comments on Q3, we believe that one option is to allow investment firms to explain (either from the outset or complementary to the assessment) the reality of the market by highlighting the available ranges of products (or the closest ones if no product matches) without this being considered as biased. For example, as part of asking preference on aspect (a) of sustainability preferences, firms should be allowed to include information regarding current taxonomy alignment without the risk of this being seen as influencing the response that will be provided by the client.

Q11. 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.

We have serious concerns with ESMA's proposal to restrict a firm's ability to recommend a product that does not meet a client's sustainability preferences to instances where the client has subsequently adapted his or her individual preferences. In the short to medium term, the combination of a requirement to ask a client without explaining the availability of products in the market, the limitation to recommend products that do not fulfil the sustainability preferences and the restriction in adjusting such preferences will, in the majority of cases, lead to situations that no product can be recommended at all.

This is based on the fact that the client's expectations of sustainability and the market reality will not match in the beginning. Please also refer to our answer to Q3 regarding the link between client exploration and the product matching phase and the challenges faced from 02 August 2022 with regards to the lack of "matching products". In detail our concerns are as follows:

First, this is not consistent with Recital 8 of the MiFID II Delegated Regulation which states: "*it is necessary to clarify that financial instruments that are not eligible for individual sustainability preferences can still be recommended by investment firms, but not as meeting individual sustainability preferences*." In addition, the Recital does not state that an adaption could not be a standard procedure (Recital 8 reads as follows: "*In order to allow for further recommendations to clients or potential clients, where financial instruments do not meet a client's sustainability preferences, the client should have the possibility to adapt information on his or her sustainability preferences. In order to prevent mis-selling and greenwashing, investment firms should keep records of the client's decision along with the client's explanation supporting the adaptation*.")

Second, especially at the beginning, and as highlighted in our response to Guideline 2, it will be of essential importance for firms to manage the (very high) clients' expectations vis-à-vis what is – at the time of the suitability assessment – available on the market. We have already provided our thoughts on how to correctly introduce sustainability preferences concepts and argued that requiring to query clients on specific legal concepts could lead to preferences that cannot be matched accordingly, as they may simply not be available on the market. If such a stringent approach were to be adopted by ESMA, it would naturally lead to numerous situations where a particular firm could not offer any (sustainability-retailed) suitable products and would either have to simply record the inability to provide products with the relevant sustainability-related features instead of suggesting to adapt the client's sustainability preferences. In line with ESMA's suggestion that such a reassessment of what is possible, at a certain point in time, should not become "standard procedure", we fail to understand how financial firms can, therefore, channel clients' money into existing sustainable finance solutions.

Third, in the current state of the market, firms will probably need to use this adaptation possibility to a great extent. Indeed, clients will probably have high expectations with regards to sustainability characteristics while the market is still in its infancy. As we explained previously, we are confident that this situation will improve over the coming years.

To ensure that investors are being presented with financial products that incorporate sustainability-related features, we propose the following in line with our previous comments:

(1) Allow more flexibility in using concepts that link to legal definitions (i.e. "client-facing" translation) rather than requiring firms to use the legal definitions of aspects (a) to (c). Again, this differentiation between concepts and legal definitions very much depends on the client type.

(2) Allow ranges for the minimum proportion of aspects (a) and (b) while not requiring concrete percentages, rather forcing firms to ensure that these ranges reflect the range of current products currently available on the market.

(3) Make a link between the client exploration and product matching phases to allow firms to indicate to clients that products with certain features or investment proportions might not be available and inform them whether or not they can offer other products that, even not match certain features or proportions, are closed thereto or otherwise aligned with clients' expressed preferences (i.e. "best matching" products for clients' preferences). We provide a number of suggestions in our response to Q3. For all suggestions (except where the clients' "ultimate" preferences are stored for future reference), it should also be clarified that if the client decides ultimately to invest in one of the

available products offered, this decision should be deemed as an accepted adaption of the respective clients' preferences.

(4) In line with Recital 8 of the Delegated Regulation, where no financial instruments are eligible for individual sustainability preferences, on a general basis allow firms to recommend others that are suitable. To allow for further recommendations, where financial instruments do not meet the client's sustainability preferences, the client should always (i.e. not exceptionally) have the possibility of adapting the relevant sustainability preferences. This consideration is of utmost importance until companies start reporting accurate data which will not be before 2024). The notion of the "standard procedure" should be removed from the guidelines and ESMA may wish to align the wording already used in paragraph 82 relating to portfolio management services to investment advice. The relevant passage of paragraph 82 reads as follows: "*If the firm cannot meet those preferences, it should discuss this with the client when agreeing on the mandate in which the investment strategy is defined and ask the client to adapt his/her preferences. The decision of the client should be documented*."

(5) A firm could be encouraged but should not be required to systematically and pro-actively monitor the instances where a client adapts his or her sustainability preferences. At least in the first few years, we see no reason for monitoring this development, as it will only reflect the range of sustainable investment products available and, depending on the Guidelines finally being adopted, the relevance of the process for ascertaining sustainability preferences.

Q12. 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.

Please see our response to Q11.

Q13. 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)?

Please see our suggestions in our responses to Q3 and Q11 which try to propose approaches when no suitable financial instruments are available. In any case, the suitability report must be adapted and allowed to be lighter for non-retail clients (cf. Guideline 8, paragraph 84).

Q14. 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.

We support ESMA's proposal to establish a firm-internal approach in case a client does not express sustainability preferences. We think that the current supporting guidelines are prescriptive enough. This being said, we would like to re-emphasise our earlier point regarding the flexibility to adapt the questions. This is important, as ESMA's formulation of the Q14 assumes that the first question to be asked is whether a client has sustainability preferences or not and we believe that this could be misconstrued to mean whether a client cares about the environment and/or society and we do not expect any client will say no to this.

Q15. 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.

Our concerns raised in Q12 are the same for portfolio management. Please see our response above.

Q16. 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?

We are not sure whether this requirement is helpful at the moment. As previously mentioned, we would suspect the main reason for adapting sustainability preferences is due to clients' expectations being too different from reality and firms should have an inherent responsibility to help bridge this gap by providing them with relevant information as part of gathering information from clients to manage clients' expectations.

GUIDELINE 10: COSTS AND BENEFITS OF SWITCHING INVESTMENTS

Q17. Do you agree with the proposed amendment to supporting guideline 10? Please also state the reasons for your answer.

We have no strong view on the proposed amendment to supporting guideline 10. However, we question whether the addition is required, as an already existing guideline and supporting guidelines are sufficiently detailed.

GUIDELINE 11: QUALIFICATIONS OF FIRM STAFF

Q18. 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.

We support the need for staff to have the necessary knowledge and competence concerning sustainability preferences and the firm's product governance processes (i.e. how and why certain products have been selected for the advisory channel), as this will be important to answer clients' questions and bridge the gap between clients' expectations and reality.

This being said, we do not think that further guidance is needed on this aspect. Investment firms providing product information and investment advice already must ensure their staff have an adequate level of skills, knowledge, and expertise. We agree that investment firms should implement training programs to ensure their staff also understand sustainability preferences and can provide clients with clear explanations and information on the topic. Assessment of their knowledge and expertise on the matter should form part of the initial and ongoing competency assessments run by investment firms.

Conceptually speaking, we are not sure if this requirement should be part of the suitability guidelines instead of the knowledge and competence guidelines given the amendments to Article 21 of the MiFID Delegated Regulation

In line with our previous comments on different investors types, we believe that para. 104 should only require staff to explain "the different aspects in non-technical terms" when addressing investors with insufficient knowledge and experience on sustainable investment products (i.e., this should not be necessary for professional investors).

Guideline 12: record-keeping

Q19. Do you agree on the guidance provided on record keeping? Please also state the reasons for your answer.

We generally agree with the guidance on record-keeping provided, but question why the second bullet point of para. 109 requires recording "the types of financial instruments that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them". Also, compulsory information keeping regarding the suitability assessment and suitability reports should be adapted for non-retail clients.

Questions not related to specific revisions

Q20. 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.

With regards to the guidelines on appropriateness and execution-only, we noted the recurring statement by ESMA that they should not be seen as a tick-the-box exercise. We are somehow missing this important message throughout these guidelines and would encourage ESMA to allow flexibility (as explained throughout our response) instead of a tick-the-box to ensure that sustainable investment products offered by investment reflect the current market reality which will certainly develop further over time.

Furthermore, where common provisions exist in the regulations for the assessment of suitability and appropriateness, we agree that the supporting guidelines related to those common provisions should be aligned to eliminate any inconsistencies mindful that the guidelines need to continue to adhere to and not go beyond the legal requirements in the relevant regulations.

Q21. Do you have any further comment or input on the draft guidelines?

While not under the sole control of ESMA, we would like to make some important remarks regarding the overall timing of the introduction of the sustainability considerations into MiFID II.

From the start, there has been an overall sequencing issue. While MiFID II's new suitability processes were meant to be based on available SFDR data, this data delivery has now been delayed to Jan 2023 (with the first available data only becoming available in Q1 2023) but the subsequent MiFID II timelines were not adapted accordingly. This leaves investment firms in an awkward position of having to consider sustainability elements with underlying data not being yet available. This is particularly the case regarding the percentage of sustainable investments and details regarding consideration of principal adverse impacts.

Second, ESMA's final guidelines will only be published after the start of the application date of the MiFID II Delegated Regulation – forcing fund managers and other investment firms to revise their

established processes “on the go”. This situation creates unnecessary costs and proves ultimately detrimental to clients.

We expected the revised product governance guidelines to be consulted simultaneously as it is paramount to ensure that the newly introduced concepts and requirements around sustainability are the same in both the suitability and product guidelines. The suitability process is partially built on the target market information and must be aligned to ensure that meaningful processes can be set up by investment firms. We are, however, still awaiting this second consultation and urge ESMA to eventually ensure that those two guidelines are aligned as much as possible, and that timing of implementation is the same in order to avoid unnecessary adjustments to internal processes.

We are also concerned regarding inconsistencies between ESMA’s proposed guidelines and EIOPA’s proposal. One of the supporting guidelines in ESMA’s consultation allows the use of ranges or sizes as long as these ranges are presented in a neutral way. However, EIOPA is of the view that ranges should not be used as this would risk preventing products with higher proportions from being recommended to the customer. In EIOPA’s consultation, there was clear emphasis regarding the use of information in pre-contractual documents in matching products with clients’ sustainability preferences. However, this is unclear within ESMA’s proposed guidelines and inconsistent with our request to provide firms with the flexibility to use both commitment and actual results during the matching process as per our response to Q4. We urge ESMA to work with EIOPA to ensure that there are no fundamental inconsistencies between the two guidelines, as otherwise clients will have different experiences depending on the guidelines being adhered to notwithstanding the concepts being operationalised are exactly the same.

Q22. Do you have any comment on the list of good and poor practices annexed to the guidelines?

No comments.

Q23. 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.

At this point, EFAMA does not have any relevant statistical data on the level of resources needed to implement the guidelines. We would like to stress, however, the overall costs incurred by the financial industry to implement these new suitability rules which relate not only to purchasing data but also to onboarding them in reports and consistently disclosing them. Misaligned implementation of the new suitability guidelines and the availability of data from 2023 adds further unnecessary costs that could have been easily avoided.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. More information available at www.efama.org.

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