ClientEarth

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ESMA Consultation Paper: Guidelines on certain aspects of the MiFID II suitability requirements

ClientEarth Consultation Response

Introduction

ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid, Beijing, Luxembourg and Los Angeles, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.

ClientEarth's Climate Finance initiative analyses the legal duties of a wide spectrum of actors in the financial system – including companies, investors, banks, insurers, pension schemes, asset managers and financial advisers – to consider, manage and report their risks and impacts associated with climate change and the environment.

This paper sets out ClientEarth's response to the European Securities and Markets Authority (**ESMA**) consultation[1] (the **Consultation**) on proposed amendments[2] to ESMA's *Guidelines on certain aspects of the MiFID II suitability requirements* (the **Guidelines**) to reflect the Commission's adoption of amendments to the MiFID II Delegated Regulation[3] (the **Delegated Regulation**), through an amending regulation[4] (the **Amending Regulation**) to require the integration of sustainability preferences into firms'

[1] ESMA, Consultation On Guidelines On Certain Aspects of the MiFID II Suitability Requirements, here.
[2] ESMA, Consultation Paper, Guidelines on Certain Aspects of the MiFID II Suitability Requirements (27 January 2022), here.
[3] Commission Delegated Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, available here.
[4] Made through Commission Delegated Regulation (EU) 2021/1253 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, available here.

advisory and portfolio management processes to ensure that clients' sustainability preferences are properly taken into account.

We have provided comments in relation to three key phases of the suitability assessment: the explanation of sustainability preferences to clients; understanding clients' sustainability preferences; and assessing suitability and matching investment products. We have specific concerns regarding how climate-related preferences are explained, understood and matched as part of the wider sustainability assessment process and have included comments on this in a separate section, explaining the implications for each phase of the suitability assessment. Finally, we have commented on the implications for investment firm and advisor competence and training.

The consultation questions are set out in the final section of this response. For each section of our comments, we have cross-referred to the consultation questions to which our comments relate. For each consultation question, we have cross-referred back to the sections of our comments which address the relevant question.

For further information or questions in relation to this response, please contact Megan Clay (mclay@clientearth.org), Robert Clarke (rclarke@clientearth.org) or Maria Petzsch (mpetzsch@clientearth.org).

Top Lines

- The explanation of sustainability preferences to clients, advisors' understanding of clients' sustainability preferences and the assessment of suitability and matching of investment products all need to go beyond the dry, technical definition of "sustainability preferences" in Article 2(7) of the Delegated Regulation to take full account of: (i) clients' granular, issue-specific sustainability priorities (such as a focus on climate change (environmental), inequality (social), or tax transparency (governance) factors); and (ii) clients' broader understanding of their own sustainability objectives in terms of impact, alignment with personal values, and financial return.

- Climate-related preferences must be addressed specifically in ESMA's guidance so that clients to whom these issues are important are not misled into selecting products that have an unsustainable emissions profile and / or negative climate impact due to a misunderstanding of what "sustainability" entails in relation to climate change.

- Firms and advisors must be required and supported to develop skills, knowledge and expertise necessary to advise competently on sustainability and climate-related preferences, including an adequate understanding of the technical concepts involved, the nuances of real-world preferences, a solid grounding in climate science and related concepts, and the full range of "sustainable" products available on the market and their features and risks.

ClientEarth comments

1. Explanation of sustainability preferences to clients

Relevant to questions: 1, 2

1.1. We agree that firms must help clients understand the concept of "sustainability preferences", the types of products included within the definition of "sustainability preferences" and the features and choices to be made in this context, as without an effective explanation, clients may not be able to accurately articulate their sustainability preferences, undermining the suitability assessment. It should not be assumed that all clients have a sophisticated understanding of what their sustainability preferences are, or of how those preferences might be understood in relation to one or other of the technical terms used in the definition of "sustainability preferences" in the Delegated Regulation.

1.2. However, we do not consider the proposed addition of paragraph 16 to the Guidelines to be sufficient to achieve this objective, and we believe the information requirement should be expanded further in order to provide an adequate explanation to clients.

1.3. Our specific concerns and recommendations are as follows:

1.3.1. The concepts by reference to which "Sustainability Preferences" are defined in the Delegated Regulation ("environmentally sustainable investments" under the EU Taxonomy Regulation[5]; "sustainable investments" under the Sustainable Finance Disclosure Regulation[6] (**SFDR**); and "principal adverse impacts" (**PAIs**)) are technical and dry and may not be naturally understood by clients. Advisors must provide a clear explanation of these concepts that ensures that the client genuinely understands them before proceeding with the sustainability assessment. ESMA should provide more detailed guidance to firms to ensure that these concepts are explained in a uniform way that clients understand, and contextualised by reference to the other understandings of "sustainability preferences" and "sustainability objectives" explained below, and the types of sustainable finance product available on the market <u>both within and outside the firm's own offerings</u>.

1.3.2. Proposed paragraph 16 suggests that firms "*should also explain what environmental, social and governance aspects mean*." This is positive as clients may understand their own sustainability preferences by reference to these categories rather than by reference to the technical definition in the Delegated Regulation. ESMA should provide more guidance to ensure that firms explain these concepts to clients consistently and in enough detail. For instance, firms should be required to explain the different elements which fall within "environmental" (e.g. climate change, water quality, biodiversity), "social" (e.g. human rights, discrimination, inequality) and "governance" (e.g. tax transparency, board independence, anti-bribery, remuneration) categories in a granular way. The Guidelines should also require firms to explain how these concepts relate to the technical categories of product included in the definition of "Sustainability Preferences" in the Delegated Regulation, and real examples of products on the market, as this may not be clear to all clients.

[5] Regulation (EU) 2020/852 of the European Parliament and of the Council, <u>here</u>.
[6] Regulation (EU) 2019/2088 of the European Parliament and of the Council, <u>here</u>.

1.3.3. Research by the 2 Degrees Investing Initiative has shown that, stripped of technical ESG and Taxonomy-related definitions, investor objectives to invest sustainably are better understood in terms of impact (the desire to have an impact in the real economy), personal values (avoiding guilt by association from investing in unsustainable things) and returns (i.e. optimising returns on investments).[7] In some cases, these objectives may align with the technical categories of investment set out in the Delegated Regulation. For example, investing in a fund that aligns a fixed percentage of investments with the EU Taxonomy definition of "environmentally sustainable investments" may satisfy an investor hoping to invest in a way that aligns with their personal values. However, in many cases, products which meet the sustainability objectives of investors may not fall neatly into these categories. For example, an investor seeking to achieve real world impact through their investment may not be satisfied by an investment in a fund classified as "Article 8" under SFDR which invests in socially "sustainable investments", or an environment-focussed fund that is aligned with EU Taxonomy objectives, but cannot demonstrate intentional, additional and measurable impact *through the investment itself* in the sense required for impact funds.[8] It is possible to imagine many other cases where reference to the categories set out in the Delegated Regulation definition of "Sustainability Preferences" will not align to, or satisfy, the client's understanding of their own sustainability objectives. ESMA's Guidelines should require firms to explain this broader category of sustainability objectives, and related concepts of impact, materiality, alignment etc. to clients as a matter of best practice, including how they relate to the technical categories of product included in the definition of "Sustainability Preferences" in the Delegated Regulation, and real examples of products on the market, as this will not be clear to many clients, including those who might typically be categorised as sophisticated investors.

1.3.4. The integration of client sustainability preferences is intended as a "top up" to the suitability assessment process,[9] implying that sustainability preferences should be fully integrated across the suitability assessment process, including in the explanation to clients. Additional paragraphs of guidance are necessary (i.e. proposed paragraph 16 plus additional paragraphs to cover the information discussed in this response) but should also be complemented by integrating sustainability considerations into the other supporting paragraphs 12 to 18 to general guideline 1 to ensure that firms are clear how those principles apply in relation to sustainability preferences.

1.3.5. In particular, the Guidelines should require firms to explain to clients that the assessment of their sustainability preferences will be largely based on self-assessment, which is different to the usual mechanism for testing suitability set out in paragraph 14 of the Guidelines.[10]

1.3.6. In order to address the issues discussed above, and ensure that sustainability preferences and objectives are consistently and clearly explained to clients, ESMA should provide more detailed guidance regarding what an adequate explanation includes. Firms

[7] See, page 15 of 2Dii, A Large Majority of Retail Clients Want to Invest Sustainably (March 2020), here.
[8] See, for example, "*Elements of Impact Investing*" at GIIN, What You Need to Know About Impact Investing, accessed 26 April 2022, here.
[9] See paragraph 4 in section 1 of the Commission's Explanatory Memorandum to the Delegated Regulation, available here.
[10] See paragraph 26 of the Consultation Paper.

should be encouraged to develop detailed explanatory materials based on this additional guidance.

1.4. As noted in section 4 below, we have specific concerns in relation to clients' understanding of the climate claims and impacts of investment products, which have implications for the explanation of sustainability preferences.

2. Understanding sustainability preferences

Relevant to questions: 3, 4, 5, 9, 10

2.1. We agree that the level of information to be collected from clients should include all aspects mentioned in the definition of "sustainability preferences" and should be granular enough to allow for a matching of the client's sustainability preferences with the sustainability-related features of financial instruments and to allow for a combination of the different aspects included under the definition of sustainability preferences.

2.2. However, this requirement must take account of the issues discussed in section 1 above in relation to the explanation of sustainability preferences to clients. In particular, the advisor's understanding of client sustainability preferences must go beyond their preferences for the technical product categories set out in the definition used in the Delegated Regulation to cover:

2.2.1. the specific environmental, social of governance factors the client wishes their investment to impact, promote, or align with at a level granular enough for the advisor to proceed to match these preferences against products with an appropriate issue-specific focus; and

2.2.2. the client's sustainability objectives in terms of impact, personal values and financial returns as discussed in paragraph 1.3.3 above.

2.3. Proposed paragraphs 25 and 26 of the Guidelines are helpful in this regard but their value is limited because they refer only to sustainability preferences as defined in the Delegated Regulation. Paragraph 25, in particular, is too similar to Article 2(7) of the Delegated Regulation and provides little meaningful guidance to advisors as to how to assess client sustainability preferences, although the requirement for firms to adopt a neutral and unbiased approach that does not influence clients' answers is important (see paragraphs 3.6 to 3.9 below).

2.4. ESMA should therefore provide significant further guidance on the process advisors should go through to identify and understand the specific sustainability issues which are important to the client and the nature of the impact, promotion or alignment the client hopes their investment will achieve. The advisor must also take steps to understand how these preferences relate to the environmental objectives set out in the EU Taxonomy, the product classifications under SFDR, the PAI framework set out in the regulatory technical standards (**RTS**) to the SFDR[11], and the variety of investment products available on the market both within and outside the firm, including through adequate explanation of these concepts to the client in the first step of the suitability assessment.

2.5. The second step set out in the subparagraphs to proposed paragraph 26 of the Guidelines suggest that firms should collect information on whether clients' sustainability preferences "have

[11] https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_1_EN_ACT_part1_v6%20(1).pdf.

a focus on either environmental, social or governance criteria or a combination of them", but this does not go far enough to encourage firms to identify the specific ESG criteria which the client is concerned with at a level which is granular enough to identify issue-specific products which are suitable for the client. For example, within environmental issues, the advisor should distinguish a focus on climate, water quality, air quality or other environmental issues.

2.6. We also have concerns in relation to the final subparagraph to proposed paragraph 26 of the Guidelines. As drafted, this suggests that if clients suggest vague sustainability preferences without specifying the specific sustainability issues with which they are concerned or their minimum expectations for impact, promotion or alignment in respect of those issues, the advisor would have wide latitude to select any product they identify as sustainable, free of any minimum sustainability-related expectations in relation to the product. We do not consider this appropriate. Firstly, if the explanation and assessment processes are adequate, the advisor should have taken steps to identify the specific expectations of the client. If a particular client is interested in broadly "sustainable" investing with no predisposition towards a particular issue or a minimum alignment or impact, then that preference must be identified proactively and not assumed by default. It is in our view highly unlikely that a client would stop at a binary sustainability preference without specifying more granular preferences when questioned appropriately. Second, if this guidance is retained, additional safeguards should be set out to avoid situations where chronically inadequate suitability assessment processes generate inappropriately generic sustainability preferences which lead to a string of inappropriate recommendations to clients.

2.7. Finally, we have specific concerns around clients' preferences in relation to the climate claims and impacts of investment products, which have implications for the understanding of sustainability preferences. These are explained in section 4 below.

3. Assessment of suitability and matching of products to preferences

Relevant to questions: 8, 9, 10, 11, 12, 13, 14

3.1. We have two main concerns about the approach taken in the Consultation and proposed new Guidelines to the assessment of suitability and the matching of products to client profile and sustainability preferences: (i) the implication that sustainability preferences are isolated from and secondary to the client's other characteristics; and (ii) the risk that clients are influenced to adapt their preferences inappropriately.

3.2. **Isolation of sustainability preferences**. The Consultation states, at paragraph 31, that "*the sustainability preferences of the client have to be assessed as a second step, once the suitability of the product has first been assessed in accordance with the criteria of knowledge and experience, financial situation and other investment objectives [of the client]."* This principle is then reflected in proposed paragraph 79 of the Guidelines.

3.3. We are concerned that the way this process is explained in the Guidelines may lead advisors to form strong views on the suitability of a given product for the client based on other characteristics (sophistication, knowledge, financial situation and other investment objectives) which the advisor is reluctant to then amend based on the client's sustainability preferences during the second step of the assessment process. In other words, this approach suggests that sustainability preferences are subsidiary or secondary to other factors when in fact they may be as important as, or more important than, any of the other factors considered during suitability assessment to the client. Moreover, the sustainability preferences and objectives of the client and the sustainability features of products available on the market are inextricably linked with the other factors such as the client's knowledge and financial investment objectives.

3.4. Therefore, although the assessment of client sustainability preferences may (in procedural terms) come after an assessment of other factors, the Guidelines should clarify that the sustainability preferences are linked to and may influence and change the other factors and that, despite being assessed second, the sustainability preferences are not secondary in importance, and may prove decisive in whether a product is suitable for the client. The decision as to whether a given product range is suitable should only be taken once sustainability preferences and other traditional factors have been assessed together.

3.5. Although the approach taken in the current Consultation proposal appears consistent with recital 5 to the Amending Regulation[12], on closer analysis there are important differences. Whereas the recital mentions the assessment of the client's sustainability preferences in a second step after assessment of other objectives and characteristics, the Consultation extends this to state that suitable products should be identified after the first step but before the second step. This is inappropriate and risks the premature presentation of inappropriate products by the advisor. The approach suggested in paragraph 3.4 above is consistent with recital five in suggesting that a suitable range of products should only be identified after the first and second assessment steps are completed.

3.6. **Pressure to amend sustainability preferences**. We are concerned by the explanation in proposed paragraph 80 of the Guidelines on how a firm can recommend a product that does not meet the initial sustainability preferences of the client, provided the client first adapts their sustainability preferences. There are two elements to this:

3.6.1. First, this leaves open the possibility that advisors may inappropriately influence clients to change their sustainability preferences in a way that makes it easier for the advisor to match products or otherwise benefits the advisor, particularly given the concerns discussed in paragraphs 3.2 to 3.5 above. It is also possible that an inadequate explanation of sustainability preferences or misunderstanding of the client's broader sustainability objectives and motivations may make it more likely that the advisor determines that the client has changed their mind.

3.6.2. Second, the Guidelines are not clear enough about the steps that should be taken when an advisor / firm cannot offer appropriate sustainable investments, but these investments are available on the market from other firms. This exacerbates the risk that the client is pressured to change or, in extreme cases, retract their sustainability preferences when the firm cannot offer a suitable product itself.

3.7. It is helpful that proposed paragraph 81 of the Guidelines explains that changing sustainability preferences should not be standard procedure and that the change should be documented in the suitability report (as should the fact the advisor / firm cannot offer any suitable products where that is the case – see proposed paragraph 84), but this does not go far enough to protect clients.

[12] Recital 5 to the Amending Regulation states that "*in order to avoid such practices or misrepresentations, investment firms providing investment advice should first assess a client's or potential client's other investment objectives, time horizon and individual circumstances, before asking for his or her potential sustainability preferences*."

3.8. In order to address the risks identified in paragraph 3.6 above:

3.8.1. When an advisor / firm cannot offer appropriate sustainable products to the client it should be required to explain that such products are or may be available elsewhere on the market and (where possible, given the knowledge of the advisor) give an indication of the general features of such appropriate products (i.e. an amendment to proposed paragraph 84 requiring proactive steps beyond documentation in the suitability report);

3.8.2. The Guidelines should require firms and advisors to have procedures in place to prevent undue influence on the client to change their sustainability preferences;

3.8.3. The Guidelines should be adjusted as suggested in paragraph 3.4 above; and

3.8.4. The Guidelines should ensure that advisers give an adequate explanation of sustainability preferences and the types and features of sustainable products on the markets before any product ranges offered by that particular advisor or firm are introduced to the client.

3.9. We agree with the suggestion in proposed paragraph 81 that any adaptation in sustainability preferences should only refer to the suitability assessment/investment advice in question and not to the client's profile in general. The Guidelines could go further by explaining that any change to a specific and granular sustainability preference (e.g. specific ESG theme or percentage allocation preference) should be as limited as possible in order to facilitate a product recommendation.

3.10. In relation to proposed paragraph 83, we broadly agree with the proposal that where a client does not express sustainability preferences, the advisor may recommend products with and without sustainability-related features. However, we would suggest that this procedure is more obviously appropriate where a client answers "no" rather than where a client does not answer the question whether they have sustainability preferences at all. We repeat our comments in paragraph 2.6 above that where at all possible, preferences (including "no" preference) must be identified proactively and not assumed by default. The Guidelines could be clearer on this distinction and encourage advisors to make appropriate checks with the client before assuming no sustainability preference when the question is not answered.

3.11. Finally, the comments in section 4 below regarding the climate-related features of investment products have implications for the assessment of suitability and matching of investment products to client preferences.

4. Climate-specific concerns

Relevant to questions: 1, 2, 3, 4, 5, 8, 9, 10, 11, 12, 13, 18

4.1. It is clear from the European Green Deal, the Commission's Action Plan on Financing Sustainable Growth, the Commissions Strategy for Financing the Transition to a Sustainable Economy[13], and the recitals to the Amending Regulation[14] that aligning finance flows with the

[13] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390.
[14] Recital 1 to the Amending Regulation states that "*The transition to a low-carbon, more sustainable, resource-efficient and circular economy in line with the Sustainable Development Goals is key to ensuring the long-term competitiveness of the economy of the Union. In 2016, the Union concluded the Paris Agreement). Article 2(1),*

temperature goals of the Paris Agreement, and therefore climate-related sustainability, is a specific focus of the EU sustainable finance regime and of the amendments to the regulation of MiFID suitability assessments, within the overall focus on sustainability. It is therefore crucial that ESMA's guidance in this area supports finance flows (including individual client investment preferences and choices) consistent with climate science and international climate goals.

4.2. This priority is more urgent than ever given the Intergovernmental Panel on Climate Change's recent conclusion that global greenhouse gas emissions must peak by 2025 and be reduced by almost half by 2030 in order to meet the Paris Agreement's 1.5 degree temperature goal.[15]

4.3. However, we are concerned that during the complex and technical exercise of explaining, understanding, and matching products to clients' sustainability preferences, clients' understanding of the climate claims, credentials and impacts of investment products recommended to them, and clients' own related climate-specific preferences may be obscured and lost.

4.4. Broadly, our concern is that the term "sustainability" may be misunderstood by clients (and advisors) as indicating specifically that a product has a sustainable climate change profile or impact (even if the primary focus of the fund is on other environmental or social factors). Although clients may not be expected to be familiar with the details of the latest climate science, they may reasonably be expected to think that a "sustainable" investment product would not include investments that contribute (on an aggregate portfolio basis or through exposure to particularly harmful companies or sectors) to emissions / warming projections above those considered "safe" by the scientific community generally (unless as part of a clearly articulated strategy to influence high-emitting companies to reduce their emissions), when in reality the product's claims and credentials relate to other (non-climate) factors and the product has a harmful impact on the climate.[16]

4.5. Similar concerns have been articulated by a group of NGOs in relation to products with sustainable investment objectives (i.e. Article 9) or promoting ESG characteristics (i.e. Article 8) under SFDR. The NGO group is concerned that the market practice of using these SFDR product categories as de facto sustainability labels may be misleading to consumers because the SFDR criteria for each category of product do not include sufficient minimum criteria to ensure that the products are sustainable. The NGO group recommends amending the SFDR rules to impose minimum criteria for Article 8 and Article 9 products including: binding engagement and stewardship requirements, robust exclusion requirements (including fossil fuel expansion), and minimum EU Taxonomy alignment and impact measurement requirements for

point (c), of the Paris Agreement sets out the objective of strengthening the response to climate change by, among others, making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."

[15] See IPCC AR6 WG III, Summary for Policymakers, available here.

[16] For the purposes of this discussion, we leave aside debate about the merits of including high-emitting investments in climate focussed funds with the aim of engaging with such investments to encourage emissions reductions, relative to strategies that exclude such investments from allocations, save to say that we would expect such strategies to be clearly explained to the client during the assessment of suitability and matching of investment products.

Article 9 products.[17] Our comments in this section are motivated by similar consumer protection concerns and the need to prevent consumers being inadvertently misled, or mis-sold products.

4.6. This risk is exacerbated by the dry and technical definition of "sustainability preferences" used in the Delegated Regulation which refers to technical product categories under SFDR and the EU Taxonomy, rather than clients' issue specific concerns or broader sustainability objectives (in terms of impact, personal values and financial return, which are better understood).

4.7. There is a valuable opportunity to mitigate this risk in ESMA's Guidelines on the suitability assessment. This would have implications for each stage of the explanation of sustainability preferences to the client, the understanding of sustainability preferences by the advisor, and the assessment of suitability and matching of products to the client's sustainability preferences. These are introduced in the table below.

4.8. Climate related risks and recommendations

The table below identifies indicative risks in relation to climate-related preferences at each stage of the suitability assessment, and suggests ways in which the ESMA Guidance could help mitigate these risks. This table is not intended to be comprehensive but to introduce the type of misunderstanding during the suitability assessment we are concerned about.

Suitability assessment stage	**Indicative Risk**	**Recommendation**
Explanation of sustainability preferences	The explanation of sustainability preferences by reference to elements (a) to (c) of the definition in Article 2(7) of the Delegated Regulation does not help the client understand the issue-specific types of sustainability preference and investment product that exist, or that "sustainable" investment products may not have a positive climate-related impact, for example if they focus on non-climate or non-environmental sustainability factors, or do not meet the "do no significant harm" criteria in the EU Taxonomy.	When explaining sustainability preferences, advisors should be required to explain specifically but in terms appropriate to the client's sophistication and sustainability- or climate- literacy: (i) how climate change can affect investment decisions and how investment decisions can affect or relate to climate change; (ii) the types of climate-related investment products available on the market; and (iii) the fact that funds considered "sustainable" may not make any climate-related claims, may not meet accepted definitions of climate-alignment or have a positive impact in relation to climate change, and may make investments which have harmful emissions profiles (for instance if the fund focuses on other sustainability factors). In our view, it would also be helpful if advisors were required to explain in broad introductory terms climate-related concepts like the Paris-Agreement, the implications of a 1.5 temperature pathway, and the concept of an investment being "aligned" with such a pathway or the Paris temperature goals, including how such alignment is achieved and measured where appropriate, in particular for clients that have indicated a preference for products that would indicate a need for explanation of these matters.

[17] See the Joint NGOs and consumer recommendations for minimum criteria for sustainable investments and products with ESG characteristics (21 February 2022), available here.

Understanding client sustainability preferences	The advisor does not collect enough specific information from the client and fails to understand that the client wishes to invest in a way that is broadly compatible with the goals of the Paris Agreement (even in cases when the client is equally or primarily focussed on other non-climate or non-environmental sustainability goals). The advisor followed the recommended "second step" in proposed paragraph 26 of the Guidelines, but identifying the broad E, S, or G focus of the client did not help the advisor understand the client's specific preferences in relation to climate change.	Advisors should be required to gather enough specific information from the client to enable them to understand whether and to what extent the client has climate-specific sustainability preferences. This is an area in which the ESMA Guidelines could provide useful specific guidance which supplements proposed paragraphs 25 and 26 – see paragraph 4.9 below.
Assessment of suitability and product matching	The advisor recommends a range of non-climate focussed products to the client which appear to match the client's broad, generic sustainability preferences and the client's preferences in relation to the technical product categories set out in Article 2(7) of the Delegated Regulation (if any). The client accepts the recommended products but does not understand (and is not informed by the advisor) that the products make no claims about their climate credentials or impact and in some cases may have an emissions profile (on a portfolio basis derived from the emissions profile of the product's underlying investments) that is inconsistent with the goals of the Paris Agreement.	By the time products are presented to the client, the advisor should have obtained a clear understanding of the client's climate-related sustainability preferences. However, to safeguard against the risk identified in this section, it would be useful if the advisor is required to provide a final warning or summary to the client in relation to the climate claims and impact of the investment products recommended as a matter of best practice. This would ensure that the client is absolutely clear about the climate-related features of the recommended investment products before making a final decision. The warning or summary and the client's decision in relation to it should be clearly documented in the sustainability assessment. Please see paragraph 4.10 below for more detail in relation to this suggestion.

4.9. To support advisors to consistently obtain sufficient understanding of clients' climate-related preferences, ESMA could provide further detailed guidance on the climate-related information advisors should obtain from clients to supplement proposed paragraphs 25 and 26 of the Guidelines. This could include:

4.9.1. whether and to what extent the client is concerned about the climate profile and impact of their investments;

4.9.2. whether such a preference takes priority over, or is subsidiary to, any other issue-specific sustainability preference the client has, and the financial return expectations of the client;

4.9.3. whether the client wishes to invest only (or to a specified extent, expressed as a percentage) in companies and products which are aligned with pathways to global temperature rises deemed sustainable or safe by the scientific community (such as those consistent with the goals of the Paris Agreement);

4.9.4. whether the client has a preference about whether non-aligned or harmful investments should be excluded from their portfolio (i.e. a preference for values-alignment and avoiding guilt by association) or included on the basis that the managers of recommended investment products will seek to influence such investments to reduce portfolio emissions (i.e. a preference for impact);[18] and

4.9.5. whether the client has any specific methodological preferences such as investments that track EU Climate Transition or Paris-Aligned Benchmarks, fall within EU Taxonomy definitions, or attract some kind of third-party verification or label.

4.10. As noted in the table above, we also recommend additional guidance requiring advisors, as a matter of best practice, to make clear to the client the extent to which recommended products make any claims about their climate profile or impact. We have suggested that this take the form of a final warning or summary to allow the advisor to double-check that the client's climate preferences have not been inadvertently overridden. Given that investment products may make no claims about their climate impact or may make claims that are hard to understand or unconvincing, the form of the warning may need to vary depending on the nature of the products recommended. For example:

4.10.1. where a "sustainable" product makes no claims about its climate profile or impact, for instance because it focuses on social factors, a binary warning may be appropriate to remind the client that the product makes no such claims and may have an unsustainable impact on the climate; and

4.10.2. where a "sustainable" product focuses specifically on climate change, or includes climate claims within a broader sustainability focus, a more nuanced warning may be appropriate to ensure the client understands:

4.10.2.1. what climate-related claims are made by the product;

4.10.2.2. what the product's climate-related investment thesis is (e.g. exclusions, annual emissions reductions, engagement);

4.10.2.3. whether the investment product aims or expects to be aligned with the Paris-Agreement temperature goals or any alternative temperature pathway; and

4.10.2.4. how this is expected to be achieved and measured (e.g. through the use of EU Benchmarks or other alignment techniques).

4.11. In making these suggestions, we acknowledge that climate impact and Paris-alignment are complex areas in which a variety of methodological approaches compete and co-exist. We would hope that ESMA could provide guidance that is useful to advisors without being overly prescriptive or favouring particular methodologies over others. The key point is that the climate implications of a given investment are clearly explained to clients. Care would also need to be taken to ensure that guidance provided by ESMA in the context of the suitability assessment aligns with wider efforts to develop regulation and best practice on labelling, climate impact and Paris-alignment at corporate and investment portfolio levels including but not limited to: the EU

[18] See paragraph 1.3.3 above for a full explanation of sustainability objectives of this nature.

Climate Transition and Paris-Aligned Benchmarks, the climate adaptation and mitigation criteria of the EU Taxonomy and the development of an EU ecolabel for retail financial products.

4.12. We also recognise that these recommendations have implications for the skills, knowledge and expertise investment firms and their staff are required to possess. This is discussed in section 5 below. While investment firms and advisers must be expected to be competent to assess client sustainability and climate-related preferences and understand and recommend appropriate products, the recommendations in this section are not intended to imply that investment firms must attempt to verify and vouch for the approach to climate change proposed by all investment products on the market, or whether such sustainability or climate-related impact claims will delivered over the life of the relevant investment. Rather, they should be expected to have sufficient understanding, in general terms, of the variations in approach and their limitations so as to be able to make appropriate recommendations to clients and to communicate clearly the associated risks.

5. Investment firm / advisor competence and training

Relevant to questions: 18

5.1. The integration of sustainability preferences into the suitability assessment has implications for the skills, knowledge and expertise investment firms and advisors are required to possess, which must be sufficient to discharge their responsibilities under MiFID.[19]

5.2. We agree with the comment in proposed paragraph 104 of the Guidelines that "*staff should also have the necessary knowledge and competence with regard to the criteria of the sustainability preferences as specified in Article 2(7) of the MiFID II Delegated Regulation and be able to explain to clients the different aspects in non-technical terms. To that effect, firms should give staff appropriate trainings*." In particular, we welcome the inference from the reference to "non-technical terms" that staff should be able to understand the link between the technical concepts used in the Delegated Regulation and the wider variety of more intuitive issue-specific preferences (i.e. specific E, S or G priorities) and sustainability objectives (impact, personal values and financial return) held by clients.

5.3. However, in our view, the Guidelines should provide more explicit guidance to firms in relation to the specific topics staff are required to understand, including:

5.3.1. specific environmental, social and governance issues and their relationship to retail investment;

5.3.2. the range of sustainable financial products available on the market and their features;

5.3.3. at least a basic understanding of climate science, key climate-related concepts such as the Paris Agreement and internationally recognised and endorsed temperature and emissions pathways such as the International Energy Agency's Net Zero by 2050 roadmap for the global energy sector[20]; and the approaches taken by investment products to climate change risk and impact; and

[19] See paragraph 103 of the Guidelines.
[20] Net Zero by 2050 – Analysis - IEA

5.3.4. the relationship between the technical elements of the definition used in the Delegated Regulation, the separate investment product categories under SFDR, issue-specific sustainability priorities and intuitive sustainability objectives (impact, personal values and financial return).

5.4. In relation to point 5.3.4 above, it is especially important that investment advisors are able to separate the classification of products according to the three limbs of the definition of "sustainability preferences" in Article 2(7) of the Delegated Regulation from the different question of how investment products are classified for the purposes of SFDR disclosures. As noted in paragraph 4.5 above, there are serious concerns that labelling investment products as Article 8 or 9 under SFDR may be misleading to consumers because it implies a baseline of sustainability credentials which may not be present. The Explanatory Memorandum to the Delegated Regulation[21] itself notes that "*whilst financial products referred to in Article 9 of the SFDR must pursue the objective of sustainable investments … financial products that fall under Article 8 of the SFDR might integrate different strategies, even including those that, despite claiming environmental, social and governance (ESG), socially responsible investing (SRI) or sustainability orientation, might lack sustainability-related materiality.*" This highlights that the concern is particularly acute in relation to Article 8 funds. For this reason, the Article 2(7) definition purposefully does not map directly onto the SFDR categories. Instead, the definition refers to sub-categories – those that align with EU Taxonomy criteria, "sustainable investment" criteria, or consider PAIs. It is essential that advisors receive sufficient training to understand this difference so that they do not simply put forward Article 8 or 9 products to meet sustainability preferences without assessing the substantive sustainability features of those products independently of any classification under SFDR for disclosure compliance purposes. Covering this important point in the context of competence and training (proposed paragraph 104 of the Guidelines) would help ensure that appropriate distinctions are made at each stage of the suitability assessment process.

Consultation questions

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.

See section 1 of our comments.

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.

See section 1 of our comments.

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

[21] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=PI_COM:C(2021)2616.

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.

See sections 2 and 4 of our comments.

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

See sections 2 and 4 of our comments.

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?

See sections 2 and 4 of our comments.

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.

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.

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.

See sections 3 and 4 of our comments.

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.

See sections 2, 3 and 4 of our comments.

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.

See sections 2, 3 and 4 of our comments.

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.

See sections 3 and 4 of our comments.

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.

See sections 3 and 4 of our comments.

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)?

See sections 3 and 4 of our comments.

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.

See section 3 of our comments.

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.

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?

Guidelines 9 - costs and complexity of equivalent products

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

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.

See sections 4 and 5 of our comments.

Guideline 12 - record-keeping

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

Other changes to the guidelines

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.

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

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

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.

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