ESMA Call for evidence: On the integration of sustainability preferences in the suitability assessment and product governance arrangement

2° Investing Initiative (**2DII**) is an independent, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals. 2DII coordinates some of the world's largest research projects on sustainable finance. Our team of finance, climate and risk experts develop research, tools and policy insights to help financial institutions and regulators hasten and adapt to the energy transition. To ensure our independence and the intellectual integrity of our work, we have a multistakeholder governance and funding structure with representatives from a diverse array of financial institutions, governments and NGOs.

In June 2023, the European Securities and Markets Authority (**ESMA**) released a call for evidence (the **CFE**) on the integration of sustainability preferences in the suitability assessment and product governance requirements.

This document provides 2DII's general comments in relation to the subject matter of the CFE together with responses to specific questions. Please do not hesitate to contact David Cooke, Law and Policy Lead (david@2degrees-investing.org) for further information on anything contained in this response.

Please see the following papers which are most relevant to the background research informing this response:

- Assessing client sustainability preferences … lost in the maze? Results of the mystery shopping campaign assessing financial advisor's compliance with new regulatory requirements for the mandatory assessment of client sustainability preferences.
- Moving the blockers of retail sustainable finance and Jumping the barriers to sustainable retail investment in France A series of seven market reports which summarise quantitative and qualitative research (quantitative surveys, bilateral interviews, focus groups, mystery shopping visits and a desk-study of the Lipper fund database) on the current situation regarding demand, supply and distribution of sustainable retail investment products in six European countries: Spain, Italy, Netherlands, Sweden, Belgium, Poland and France.

General comments

Mystery shopping campaign results and analysis

2DII has a longstanding and extensive research programme in relation to investment firm market practice for the suitability assessment. This research programme covers consumer research in relation to how retail clients approach and articulate the sustainability considerations associated with their investments,[1] mystery shopping campaigns to assess financial advisor behaviour in relation to client preferences for sustainable investment,[2] and regulatory and policy analysis. This response draws from this research programme and in particular our most recent mystery shopping campaign to assess advisor behaviour in the context of the new regulatory requirements to assess sustainability preferences.

Our mystery shopping research focus is in three main themes:

- Assessing the level of compliance with the regulatory provisions which introduce a mandatory assessment of client sustainability preferences during the suitability assessment.
- Testing the limits of the regulatory definition of *sustainability preferences* to enable a holistic assessment of client preferences for sustainable investment.
- Assessing the level of sustainable finance knowledge by financial advisors to provide financial product recommendations to clients with sustainability preferences.

Broadly speaking our mystery shopping campaign reveals the following picture in relation to the assessment of sustainability preferences during the suitability assessment.

The results reveal an alarmingly low level of regulatory compliance. According to the current campaign average (EU9) result, in only 43% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. Therefore the level of regulatory compliance appears to be less than half. The results also reveal significant variability in the level of regulatory compliance across different countries (ranging from 13% to 74%). If one aim of the delegated regulation is to harmonise market practice, then these results clearly indicate this has not yet been achieved.

For the explanation of sustainability preferences,[3] the current campaign average (EU9) result is that advisors provide an explanation of sustainability preferences in 83% of appointments. However, the broad observation that advisors often link the explanation of sustainability preferences to environmental or social considerations but any explanation of key concepts such as principal adverse impacts etc. was not adequate is very apparent. This means that clients cannot be regarded as sufficiently empowered to take informed decisions (unless they have done their own research outside of the appointment).

The results also show that few advisors are assessing the minimum proportion of investments which should be invested in accordance with sustainability preferences.[4] According to the current campaign average (EU9) result, the advisor did not assess the minimum proportion to be invested in accordance with sustainability preferences in 49% of appointments. In addition, the results raise questions as to whether record keeping by advisors is adequate.[5]

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[1] See most recently: 2DII, 2023, *Moving the blockers of retail sustainable finance* (a series of six market reports which summarise quantitative and qualitative research (quantitative surveys, bilateral interviews, focus groups, mystery shopping visits and a desk-study of the Lipper fund database) on the current situation regarding demand, supply and distribution of sustainable retail investment products in six European countries: Spain, Italy, Netherlands, Sweden, Belgium and Poland); 2DII, 2022, *What do your clients actually want? Understanding and estimating household demand for sustainable financial products*

[2] See most recently: 2DII, 2023, *Moving the blockers of retail sustainable finance*; 2DII, 2023, *Assessing client sustainability preferences … lost in the maze?;* 2DII, 2022, *Please Don't Let The Be Misunderstood! How financial advisors consider clients' sustainability motivations before the upcoming MiFID II Delegated Act*

[3] Required by Recital 6, Commission Delegated Regulation and as referred to in Paragraph 16, ESMA Guidelines

[4] Assessing the minimum proportion is necessary for Category A and Category B of sustainability preferences.

[5] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

While seemingly innocuous, these results raise concerns about whether the regulatory changes are effective in contributing to the desired policy objective. In theory, the procedure articulated in the regulatory changes should create an incentive structure so that over time the financial product offering changes to reflect increasing client preferences for sustainable investment. However, if the minimum proportion to be invested in accordance with sustainability preferences (i.e. a key constituent of the original articulation of client sustainability preferences) is not being assessed, and the record keeping at both this step of the suitability assessment and the step when the client is given the opportunity to adapt its sustainability preferences is not adequate, then there is no evidence as to the extent to which clients are adapting their sustainability preferences. And in turn, where there is no such evidence, it is unlikely that there will be any incentive structure for investment firms to change the profile of their financial product offering.

Without this incentive structure, the whole theory of change for EU sustainable finance policy (in relation to ensuring financial institutions take account of increasing client preferences for sustainable investment meaning that these client preferences are leveraged in support of reorienting finance towards sustainable investment) is critically undermined.

Recommendations

We have expressed elsewhere[6] our concerns about the level of regulatory oversight afforded to the suitability assessment. The general obligation of competent authorities in respect of supervision[7] is very broadly drafted. There are no explicit provisions which relate to regulatory oversight of the suitability assessment and any regulatory oversight which does occur will be largely dependent on record keeping obligations which apply to financial institutions.

We consider that the planned route to integrating assessment of client preferences for sustainable investment into the suitability assessment relies on a level of regulatory oversight which may not exist. Addressing this oversight gap at national level is critical to create an enabling environment which is compatible with integrating sustainability considerations. And greater coordination at EU level is necessary to work towards harmonisation of approaches across the EU.

In this context and in view of what our results reveal about current market behaviour in terms of regulatory compliance, there is a clear need for a coordinated review at the earliest opportunity.[8] This must be framed in terms of both assessing the level of regulatory compliance and whether the regulatory framework is designed to effectively contribute towards the policy objective.

Recommendation 1: *Carry out a coordinated review as soon as possible to assess the level of regulatory compliance with the new suitability assessment requirements and whether the procedure articulated for assessment of sustainability preferences is appropriately designed to contribute towards the policy objective of reorienting finance towards a sustainable economy*

The results of our mystery shopping campaign provide further evidence to support our recommendation in previous papers[9] that the definition of sustainability preferences must be clarified and improved. And clarifying the concept of sustainability preferences will also require an improved approach to sustainable product categorisation than currently described in the SFDR. Absent an improved method of sustainable product categorisation, much of the regulatory architecture to support the improved concept of sustainability preferences will be missing.

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[6] See 2DII, 2022, *Integrating client preferences for sustainable investment … still a way to go* and 2DII, 2022, *Fighting greenwashing … what do we really need?*

[7] Article 22 Directive 2014/65

[8] The peer review of competent authorities (as referred to in Art 30, Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC) appears to be grant ESMA the authority to conduct reviews which can include an assessment of 'the effectiveness and the degree of convergence reached in the application of Union law and in supervisory practice' and 'the extent to which the supervisory practice achieves the objectives set out in Union law.'

[9] 2DII, 2022, *Integrating client preferences for sustainable investment … still a way to go*, 2DII, 2022, *Fighting greenwashing … what do we really need?* 2DII, 2022, *Jumping the barriers to sustainable retail investment in France*

Other jurisdictions[10] are progressing with an approach to sustainable product categorisation which is more reflective of both (1) the myriad of factors, objectives and motivations which retail investors have for the sustainability aspects of their investments and (2) the tangible product features which identify and differentiate different categories of financial product. The net result is that different categories of financial products are more clearly delineated from each other and matching client preferences for sustainable investment (including the currently ignored impact-oriented clients) to financial products is more accurate.

The Commission is currently carrying out a comprehensive assessment of the SFDR[11] and anecdotal evidence points to a public consultation before the end of 2023 (although the Commission has not announced anything formal in this regard). We consider that this comprehensive assessment of the SFDR must improve the method of categorisation of sustainable financial products than is currently apparent (e.g. Art 6, 8 and 9) and that there must be consequent amendment to the definition of sustainability preferences to ensure consistency.

Recommendation 2: *The ongoing comprehensive assessment of the SFDR must be used to clarify sustainable financial product categorisation and to integrate the concept of "investor impact" which should be followed by consequent amendments to the definition of sustainability preferences.*

The *Retail Investment Strategy*[12] (announced in May 2023) includes proposed measures to strengthen and harmonise requirements on knowledge and competence of advisors. Specific requirements which are currently stipulated in ESMA Guidelines will be promoted to legal requirements and an additional element regarding sustainable investments will be introduced.[13] Compliance with these requirements will need to be proven by obtaining a certificate and a limited requirement for ongoing professional training will be introduced.

The results of our mystery shopping campaign demonstrate that knowledge and competence in relation to sustainable finance differs widely and that the average level of knowledge and competence of financial advisors is not sufficient to comply with the new requirements for assessment of sustainability preferences. In this context defining precise and comprehensive requirements around knowledge and competence for the *additional element regarding sustainable investment* (as referred to above) is critical to articulate the minimum level of knowledge to ensure that financial advisors have sufficient expertise on sustainable finance to carry out a comprehensive suitability assessment.

Recommendation 3: *Use the upcoming measures to improve knowledge and competence of financial advisors announced under the Retail Investment Strategy to define precise and comprehensive requirements around sustainable finance knowledge and competence.*

[10] In the UK, the FCA's most recent proposals for sustainable investment labels proposes three categories: Sustainable Focus, Sustainable Improvers and Sustainable Impact (see FCA, 2022, CP22/20 *Sustainability Disclosure Requirements (SDR) and investment labels).*
[11] https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en
[12] https://finance.ec.europa.eu/publications/retail-investment-strategy_en
[13] https://ec.europa.eu/commission/presscorner/detail/en/qanda_23_2869

Responses to specific questions

Q1: What actions did firms implement within their organisation to take into account the new requirements related to sustainability preferences? Please elaborate especially on the following:

- **What proportion of firms' employees (differentiating between client facing staff and the other staff) have received training on sustainability topics? What these trainings consisted of? Was any test or exam put in place?**
- **Which conflicts of interest relating to the integration of clients' sustainability preferences did firms identify and which measures did firms take to ensure that these conflicts of interest do not damage the interest of clients?**

2DII has no evidence in relation to the specific actions which firms have implemented within their organisation to take into account the new requirements related to sustainability preferences. However, we would highlight that the results of our mystery shopping campaign (revealing a low level of regulatory compliance generally and raising concerns about the level of advisor sustainable finance knowledge) would indicate that these measures are not yet comprehensive, market wide or sufficient.

Q2: Are there specific aspects of sustainable finance that retail investors struggle to understand? For example: Understanding of general aspects such as why it is important to consider sustainability risks and factors when investing?

- **Understanding differences between sustainable products and products without sustainability features?**
- **Understanding that sustainability characteristics and (expected) return are two separate issues?**
- **Understanding the new legal definition of "sustainability preferences" and its components (e.g., categories a), b) and c), minimum proportion, principal adverse impact indicators (PAIs), etc)?**

2DII has conducted consumer surveys over the past three years in 14 European countries to better understand retail investor motivations and preferences for sustainable investing. In our latest survey of retail investors in Belgium, Spain, Italy, Netherlands, Poland and Sweden, we asked about their beliefs about the implications on financial returns of integrating sustainability factors in an investment strategy. On average, 31% believed that integrating sustainability factors in an investment strategy tends to improve financial returns and only 19% believed it would downgrade financial returns, while 24% expected no significant effect on returns (26% did not have a strong idea about the question).

However, in terms of retail investor understanding of key aspects of sustainable investing (e.g. the new legal definition of sustainability preferences etc.) we have significant concerns about whether advisors are doing enough to enable informed decision making. The results of our mystery shopping campaign show that advisors often link the explanation of sustainability preferences to environmental or social considerations but any explanation of key concepts such as principal adverse impacts etc. was not adequate. This means that clients cannot be regarded as sufficiently empowered to take informed decisions (unless they have done their own research outside of the appointment).

In addition, the results of our mystery shopping campaign reveal significant concerns as to whether the definition of sustainability preferences provides a sound basis for a comprehensive and holistic assessment of client preferences for sustainability investment. Indeed we have a fear that approaching the topic of client preferences for sustainable investment through the lens of the definition of sustainability preferences (as now required by the Commission Delegated Regulation) serves only to muddy the water and makes an already complicated area even more so.

In aggregate, the results show significant limitations to the regulatory definition of sustainability preferences. The definition does not accommodate impact-oriented financial products (which a significant proportion of clients would be interested in), and it does not operate at the same level of detail (e.g. in relation to specific sustainability topics) which many clients approach the sustainability considerations for their investments.

The results create doubt that an adherence to the regulatory definition of sustainability preferences as a means to assess client preferences for sustainable investment may not work in either the client or the advisor interest. Adhering to the concept of sustainability preferences effectively backs the advisor into speaking a different language to clients – and this then creates a risk of mis selling and significantly undermines the procedure articulated for the assessment of sustainability preferences during the suitability assessment.

Q3: Are there specific financial education initiatives on sustainable finance developed by consumer associations, trade associations or other organisations and that are used by investment firms that you can bring to ESMA's attention? Please accompany your reply with any relevant background information on the initiative and/or with details on its effectiveness/usefulness.

We would take this opportunity to publicise 2DII's best-practice Questionnaire and a Guidance (available on our website) to assist investment firms in carrying out a comprehensive assessment of a client's sustainability preferences and wider sustainability motivations to comply with the new regulation and to their client expectations. This Guidance and Questionnaire were developed considering: (i) the relevant regulatory framework and any supervisory guidance materials; (ii) 2DII expertise and research in relation to assessing client preferences for sustainable investment; and (iii) extensive stakeholder feedback through working group discussions, public consultation and interviews and focus group sessions.[14]

And thanks to funding from the European Commission and national governments in Germany, France and Switzerland, 2DII has developed over the last three years a unique information source for retail investors (and financial advisors) on sustainable investing: myfairmoney.eu. This independent and public platform includes extensive information resources such as a video course on sustainable finance, a podcast on impact investing, a sustainability questionnaire, preparation materials for meeting a financial advisor and other tips and information. In addition to this international information source, there are also several national educational initiatives mostly developed by consumer organisations. For example, BetterFinance has launched an education section on their website which includes a map with national sustainable finance educational initiatives: https://betterfinance.eu/greencorner/investor-education/

Q4: What is the main way firms currently provide information to retail clients about sustainable finance? For example:

- **Orally during the meetings with clients**
- **Through educational brochures or other (paper) documents**
- **Through dedicated website and apps**
- **A combination of the above**
- **Other**

In your opinion, are these approaches effective? Please provide details. Are retail clients satisfied with the quality of information provided?

We have no specific data on the main ways in which firms provide the explanation of sustainability preferences and other relevant considerations. However, in our best practice Guidance and Questionnaire we recommend that investment firms should develop client explanatory materials to ensure the explanation of sustainability preferences is effective and enable control checks to take place.

Otherwise our mystery shopping campaign results are somewhat contradictory on this point. On the one hand, the current campaign average (EU9) result is that advisors provide an explanation of sustainability preferences in 83% of appointments. In addition, the advisor checked whether the mystery shopper understood the explanation of sustainability preferences in 70% of appointments. But on the other hand, the broad

[14] The original version of the Guidance and Questionnaire was developed through a working group established under the Finance ClimAct project in France and composed of around 20 members drawn from financial institutions, academia and civil society. 2DII also conducted a public consultation on a draft Guidance and Questionnaire from March to June 2022 and carried out a series of online focus groups and interviews in May 2023 to develop this second version of the Guidance and Questionnaire.

observation that advisors often link the explanation of sustainability preferences to environmental or social considerations but any explanation of key concepts such as principal adverse impacts etc. was not adequate is very apparent.

In addition, many mystery shoppers did not reveal any concerns about the level of sustainable finance knowledge of the advisor. While at first glance this appears a positive result, we think the results could reveal something less comforting. The fact that many mystery shoppers did not articulate concerns about the level of sustainable finance knowledge of the advisor is inconsistent with other results gained from the mystery shopping campaign which reveal low levels of regulatory compliance generally (and low levels of compliance with constituent parts of regulatory procedure) and generally poor level of knowledge by advisors in relation to accommodating impact-oriented investment opportunities, specific environmental topics and avoiding harmful activities.

One would ordinarily infer from these other results that advisors do in fact have low levels of knowledge – but it appears to be the case that this is not apparent to many clients themselves. It may be that an advisor's professional approach, experience and confidence in relation to other more established areas of financial advice can mask a lack of specific sustainable finance knowledge. Therefore this raises the question whether this is a situation of both client and advisor being *lost in the maze*. Whether it is in fact the case that advisors have low levels of knowledge (either in terms of knowledge and competence on key sustainable finance topics or in terms of what is required by the regulatory procedure for the assessment of sustainability preferences) but that clients do not themselves have sufficient knowledge to be in a position where the low advisor knowledge is noticeable and apparent to them.

Q5: What are clients' experiences/reactions to the new questionnaires including questions on "sustainability preferences"? (e.g. do they require guidance to be able to answer to the questions? Do they show interest in the topic?)

No response – 2DII has no (direct) evidence in relation to this.

Q6: Are there practical examples of questions used to collect information from clients on their sustainability preferences that you can share with ESMA? (as for other parts of this CfE, respondents can opt for their input to ESMA not to be made public)

We would take this opportunity to publicise 2DII's best-practice Questionnaire and a Guidance to assist investment firms in carrying out a comprehensive assessment of a client's sustainability preferences and wider sustainability motivations to comply with the new regulation and to their client expectations.

This Guidance and Questionnaire were developed considering: (i) the relevant regulatory framework and any supervisory guidance materials; (ii) 2DII expertise and research in relation to assessing client preferences for sustainable investment; and (iii) extensive stakeholder feedback through working group discussions, public consultation and interviews and focus group sessions.[15]

Q7: Which of the sustainable investment definitions do clients most often opt for? (EU Taxonomy alignment? Sustainable investment within the meaning of SFDR? Consideration of PAI? All of them?) Please provide any statistics, where available.

No response – 2DII has no evidence in relation to this because as per the EBA's methodological guide[16] to mystery shopping, our mystery shopping campaign used pre-defined profiles in relation to client sustainability preferences.

[15] The original version of the Guidance and Questionnaire was developed through a working group established under the Finance ClimAct project in France and composed of around 20 members drawn from financial institutions, academia and civil society. 2DII also conducted a public consultation on a draft Guidance and Questionnaire from March to June 2022 and carried out a series of online focus groups and interviews in May 2023 to develop this second version of the Guidance and Questionnaire.
[16] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*

Q8: How are firms collecting information from clients on their preferences concerning the minimum proportion? With regards to the use of standardised minimum proportions, which standardised minimum proportions are presented to clients?

2DII has significant concerns that there is a poor level of regulatory compliance in relation to assessing the minimum proportion. According to the current campaign average (EU9) result, the advisor did not assess the minimum proportion to be invested in accordance with sustainability preferences in 49% of appointments. Meanwhile the advisor presented ranges for assessing the minimum proportion to be invested in accordance with sustainability preferences in 24% of cases. One limitation of the mystery shopping campaign is that it was not possible to have access to these materials to assess if these ranges were likely to influence how clients articulate the minimum proportion.

In addition, the results raise questions as to whether record keeping by advisors is adequate.[17] This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q9: What is approximately the average minimum proportion of sustainable investments requested by clients? Please provide details, where available.

No response – 2DII has no evidence in relation to this because as per the EBA's methodological guide[18] to mystery shopping, our mystery shopping campaign used pre-defined profiles in relation to client sustainability preferences.

Q10: Are firms currently able to satisfy the sustainability preferences expressed by clients (in particular in relation to the three categories (Taxonomy, SFDR, PAI))? If so, for which categories and/or types of financial instruments do firms find it most difficult to satisfy clients' preferences?

The results of our mystery shopping campaign reveal significant concerns as to whether the definition of sustainability preferences provides a sound basis for a comprehensive and holistic assessment of client preferences for sustainability investment. Indeed we have a fear that approaching the topic of client preferences for sustainable investment through the lens of the definition of sustainability preferences serves only to make an already complicated task even more so.

There is significant uncertainty in relation to how impact-oriented financial products are accommodated (if at all) in the definition of sustainability preferences. And when it comes to being able to prove/demonstrate the impact or any financial product or investment, evaluation requires a complex counterfactual analysis as impact is the additional effect on the world through an action.[19] Even if well-established and commonly used within public policy and philanthropy, those counterfactual impact evaluation techniques are still largely un-used in the finance sector. This means that much of the thinking and associated marketing communications as to the environmental impact of financial products and financial institutions is not backed up by evidence or substantiated.[20] In this context, there is a question as to how are advisors communicating on the environmental impact of financial products to impact-oriented clients during the suitability assessment?

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[17] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.
[18] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*
[19] Beyond presenting the actions that have been deployed to achieve impact, demonstrating investor impact implies providing evidence of additional outcomes in the real economy. The highest level of proof of additionality cannot be achieved without running experimental or quasi-experimental scientific methods that compare actual achievements to a counterfactual scenario where the investment would not have been made.
[20] Please see further analysis of this problem in 2DII, 2021*, Sustainable finance and market integrity: promise only what you can deliver. A regulatory perspective on environmental impact claims associated with sustainable retail funds in France* and 2DII, 2022, *Fighting greenwashing … what do we really need?*

When it comes to accommodating an impact focus in the financial product recommendation, generally this is not achieved.[21] The qualitative results here generally reveal that advisors have a lack of knowledge on investor impact. Many advisors explain that a given financial product is impactful without clearly articulating or explaining the concept or providing a technically accurate justification (see above). This is largely the same as what we have observed in previous mystery shopping campaigns.

In addition, we would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[22] This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q11: How often has the adaptation of clients' sustainability preferences been necessary during these first months of application of the rules (e.g. in terms of percentage considering new clients and existing clients whose profiles have already been updated to include information on sustainability preferences)?

We would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[23] According to the current campaign average (EU9) result, mystery shoppers provided feedback that the advisor did not take notes in 22% of appointments in relation to whether the clients adapt their sustainability preferences. This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q12: What kind of operational arrangements have firms put in place to allow clients to adapt their sustainability preferences?

We would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[24] According to the current campaign average (EU9) result, mystery shoppers provided feedback that the advisor did not take notes in 22% of appointments in relation to whether the clients adapt their sustainability preferences. This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q13: How were clients informed about the possibility to adapt their preferences?

We would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[25] According to the current campaign average (EU9) result, mystery shoppers provided feedback that the advisor did not take notes in 22% of appointments in relation to whether the clients adapt their sustainability preferences. This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q14: Have firms imposed limits on how frequently a client can adapt its sustainability preferences during the investment advice?

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[21] Note the comment above that most mystery shoppers (74% according to the current campaign average (EU9) result) received a financial product recommendation. This is a surprising result given that the mystery shopper profiles were designed with sustainability preferences which the product offer of many financial institutions would not be able to satisfy – which is especially the case in relation to impact-oriented clients.

[22] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[23] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[24] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[25] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

No response – 2DII has no evidence in relation to this.

Q15: If available: what percentage of those who adapted decided to (1) lower the level of ambition within an option (i.e. reducing the "minimum proportion" or lowering the threshold of sustainable investments in a portfolio), (2) change between the three options (i.e. categories a, b and c) (3) opt for a combination/ for a different combination between the three options (i.e. categories a, b and c) (4) express no sustainability preferences anymore.

We would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[26] According to the current campaign average (EU9) result, mystery shoppers provided feedback that the advisor did not take notes in 22% of appointments in relation to whether the clients adapt their sustainability preferences. This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q16: How often did clients refrain from adapting their sustainability preferences, accepting that the firm could not recommend any financial instruments or invest on their behalf?

We would repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[27] According to the current campaign average (EU9) result, mystery shoppers provided feedback that the advisor did not take notes in 22% of appointments in relation to whether the clients adapt their sustainability preferences. This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q17: In relation to the update of clients' profiles:

- **Which percentage/average proportion of clients have updated their (MiFID) profiles following the entry into application of the new regime on 2 August 2022?**
- **On average, taking into account the number of clients whose profile has already been updated, what is the proportion of clients who express sustainability preferences in your firm/jurisdiction?**
- **On average, taking into account the number of clients who express sustainability preferences, what is the proportion of clients that have expressed a specific preference for one or more of the three categories (Taxonomy, SFDR, PAI) in your firm/jurisdiction? (How many clients are only expressing whether or not they have sustainability preferences i.e. yes, no?).**

No response – 2DII has no evidence in relation to this.

Q18: Do you have any comment on the above practical examples?

Anecdotal market evidence in Germany revealed a high variation of client profiles with (or without) sustainability preferences among different product distributors. In the context of our active participation in different expert discussions in industry events such as the MiFID II workshops organised by Prof. Klein from University Kassel, the annual sustainability conference of the Federal Investment and Asset Management (BVI) or the International Financial Services Conference we heard from different industry participants the implicit claim that many retail investors in Europe might not be interested in sustainable financial products. We would flag that this claim contradicts the scientific results which were gathered over the last ten years on sustainability preferences and should be scrutinized carefully.[28]

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[26] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[27] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[28] See our research on sustainability preferences of retail investors in 14 European countries on our website and a (non-exhaustive) summary table of scientific literature on sustainability preferences here: 2DII, 2020, *A Large Majority of Retail Clients Want to Invest Sustainably*

We disagree with this view and based on our market insights and research results think there are a number of other reasons to explain the low level of sustainability preferences in average:

- As explained elsewhere in our response, our mystery shopping visits in nine European countries indicate an alarmingly low level of regulatory compliance. According to the current campaign average (EU9) result, in only 43% of appointments did the advisor bring up the subject of sustainability preferences without any prompting by the client. Hence, it is unclear to which extent the current low positive response rates are based on inadequate assessment of sustainability preferences (i.e. the advisor notes that the client has no sustainability preferences although he/she did not assess them).
- Indeed, an internal (undisclosed) survey of the Bundesverband Finanzdienstleistungen (AfW), which is representing the interests of independent financial advisors in Germany, showed that many independent advisors note that their clients had no sustainability preferences although they did not assess them. Furthermore, their survey showed that many advisors recommend to their clients to formally refuse sustainability preferences to not restrict the total portfolio of recommendable products (including "sustainable" products which might not match the regulatory requirements). In bilateral exchanges with larger distributor networks, we also understood that they assume that his behaviour might occur among their advisors. The main explanation for this behaviour was that some financial advisors feel too restricted by the regulatory requirements and/or they don't have enough expertise and/or not enough financial products left in case a client expresses specific sustainability preference. Hence, it is unclear to which extent the current low positive response rates are based on the financial advisors' recommendation to their clients to formally refuse sustainability preferences (to stay more flexible in their product recommendation).
- As explained elsewhere in our response, our mystery shopping campaign also indicates an insufficient preparation by a large share of financial advisors and their organisations to accommodate retail investors with sustainability preferences and wider sustainability motivations. This was reflected in the low levels of regulatory compliance generally (and low levels of compliance with constituent parts of regulatory procedure) and generally poor practice in relation to accommodating impact-oriented investment opportunities, specific environmental topics and avoiding harmful activities. Hence, it is unclear to which extent the current low positive response rates are based on the insufficient preparation and/or lack of explanation of sustainability preferences. Quality standards for financial advisor training, especially on the concept of investor impact (which is relevant for 50% of European retail investors), and better oversight is needed.
- We had access to some parts of (undisclosed) suitability questionnaires from large product distributors in Germany. All questionnaires we have seen so far duplicated the regulatory language from MiFID II to a large extent. While we do not have evidence to what extent the technical questionnaire language is used during the interactions with the client, we assume that many clients feel overwhelmed by the regulatory terms and concepts (e.g. Taxonomy, sustainable investing, PAI, minimum proportion etc.) and refuse sustainability preferences for this reason. Hence, it is unclear to which extent the current low positive response rates are based on insufficient preparation and/or inadequate explanation of sustainability preferences. Greater consistency between MiFID II and SFDR, and the implementation of a "bridge question" to assess the technical concept of sustainability preferences in MiFID II in simple words is needed. Such a "bridge question" could be similar to the question about financial risk preferences. Here, financial advisors ask how the client feels when share prices are moving 20% per year. The advisor will then translate the answer into a recommendation of a specific risk category (normally between 1-7).

Q19: Have firms implemented an approach similar to the one described in examples 1 and 2? If yes, which of the two approaches have firms implemented? If firms have implemented a different approach, please provide further details.

No response – 2DII has no direct evidence in relation to this.

Q20: What are the issues that firms encountered in the application of the requirements at portfolio level?

No response – 2DII has no direct evidence in relation to this.

Q21: How are clients' sustainability preferences gathered on the consideration of PAIs? Do firms refer to the PAI indicators listed in Annex I of the SFDR Delegation Regulation exclusively, or may clients express their preferences based on other PAIs? If clients may express their preferences based on other PAIs: what are those PAIs and how were they identified?

No response – 2DII has no direct evidence in relation to this.

Q22: May clients determine qualitative elements in order to demonstrate the consideration of PAIs?

- **If so, what are these qualitative elements and how were they identified, how is the information on qualitative elements gathered?**
- **If not, what are the challenges preventing you from offering such possibility to clients? How could these challenges be overcome?**

In our mystery shopping campaign in Denmark, Estonia, Germany, Greece, Ireland and Romania, we created one mystery shopping profile which makes it clear that negative impacts should be considered and reduced through the investment (sustainability preference category C). We wanted to know how advisors respond and/or provide an explanation when a client expresses a desire to make sure that any investments are considering the negative impacts of investee companies and aiming to reduce these impacts. According to our average (EU6) result, 50% of advisors answered this is not possible, 17% of advisors said that the fund can show that it has less negative impact (on e.g. climate change) than other funds, another 17% of advisors said that the fund can show that it excludes the companies with most negative impact and 20% of advisors responded that engagement can be used to change company behaviour (while 33% provided other explanations).

We also wanted to know how advisors respond when a client asks the advisor to select a fund which uses its voting power on the general annual meetings to reduce the negative impact on the climate (i.e. sustainability preference category C with engagement as strategy to reduce principal adverse impacts). According to our average (EU6) result, 23% of advisors answered they don't have such a fund and 21% of advisors stated that this is not possible because there is not enough data. In contrast, 43% of advisors responded that this is possible (while 13% of advisors provided other answers). However, according to our environment impact analysis of around 450 Art. 8 and 9 funds available to retail clients in the EU, we found that in most cases public disclosures on engagement and voting were insufficient to assess whether a fund which claims to "achieve positive effects" or to "reduce negative impacts" through stewardship can be substantiated.[29]

Currently, only two data fields relate to stewardship (number 21 and 22) in the European ESG EET data template which is used for systematic and structured data exchange between product manufacturers and distributors. These data fields include information on stewardship codes which may have been adopted and an internet address where the client is supposed to find all relevant information regarding stewardship.[30] This indicates that the data exchange between product manufacturers and distributors (about product manufacturer stewardship to reduce negative adverse impact) is inadequate. At the same time, research from InfluenceMap and ShareAction on the engagement and voting performance of the world's largest asset managers indicates that only a small share of public market funds managed by asset managers have credible and impactful engagement and voting performances.[31] These findings indicate a serious risk of misleading advice across Europe to (impact-oriented) clients who fall under sustainability preference category C and who want to use stewardship strategies to reduce the negative impact of the companies in their portfolio.

[29] See 2DII, 2023, *Market review of environmental impact claims of retail investment funds in Europe*
[30] See findatex.eu
[31] See Influence Map, 2023, Asset Managers & Climate Change 2023 and ShareAction, 2023, Point of No Returns 2023

Therefore the lack of detailed disclosures on sustainability-related engagement and voting is a key challenge to effectively discussing the aspects of sustainability preference category C with retail clients. This is especially relevant in the context of the consideration of principal adverse impacts (PAIs) by using investor engagement (as referred to in the SFDR reporting template and sustainability preferences category C). Clear guidance or a European sustainable stewardship code is necessary to address this issue. This would address green/impact washing risks for retail investors and at the same time asset managers with credible and effective stewardship activities would likely benefit from such market standards (since it would reveal free riding behaviour from competitors with uncredible and ineffective stewardship activities).

Furthermore, in our mystery shopping campaign in Denmark, Estonia, Germany, Greece, Ireland and Romania, the above mentioned mystery shopper profile (which makes it clear that negative impacts should be considered and reduced through the investment (sustainability preference category C)) asked what was meant by the Do No Significant Harm principle and whether it can be guaranteed human rights are respected by investee companies. According to our average (EU6) result ,15% of advisors responded that only serious human rights violations are avoided, 67% of advisors stated that it is guaranteed that human rights are respected by the companies in the funds they recommend (and 18% of advisors provided other explanations). In our mystery shopping campaign 2023 in Italy, the Netherlands and Spain (plus another 8 visits in Sweden) all mystery shoppers asked their advisors whether it can be guaranteed that human rights are respected by companies which are invested in. According to the average result for this EU4 sample, 5% of advisors responded that it means that only serious human rights violations are avoided, while 85% of advisors stated that it is guaranteed that the human rights are respected by the companies in the funds they recommend (and 9% of advisors provided other explanations). After checking the product recommendation by those advisors who guaranteed that that human rights are respected by the companies in the funds they recommend, we found that 79% of the funds were flagged under the serious human rights violation flag from the ESG rating provider ISS ESG.[32]

These results might partly be explained through different ESG data providers using less strict definitions or less granular analysis of human rights violations or selecting a lower threshold for the definition of human rights violations by the fund manager. Furthermore, some fund managers might not include fund of funds in their human rights screening or just ignore the flags. Nevertheless, these findings indicate a serious risk of misleading advice across Europe to clients who fall under sustainability preference category C and who want to exclude companies linked to any serious human rights violations. Hence, these findings highlight again the need for defining a serious human rights violation and thresholds under the DNSH concept in SFDR and the minimum safeguards concept under the Taxonomy Regulation.

Q23: What are the issues that firms encountered in the consideration of PAIs from clients?

Please see our response to Q22.

Q24: Does this correspond to practices adopted by firms? If firms have implemented a different approach, please provide further details.

No response – 2DII has no evidence in relation to this because as per the EBA's methodological guide[33] to mystery shopping, our mystery shopping campaign used pre-defined profiles in relation to client sustainability preferences.

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[32] We used our public MyFairMoney fund database (myfairmoney.eu/fund-database) with over 16.000 European retail funds to analyse the recommended funds. We could find 31% of the recommended fund products in our product database, while 79% of them were flagged under the ISS ESG serious human rights violation flag (defined by the ISS ESG industry standard threshold). This includes violations of international human rights standards, such as the International Bill of Human Rights, the International Covenant on Civil and Political Rights (ICCPR) or the International Covenant on Economic, Social and Cultural Rights (ICESCR), among others. Assessments are updated by ISS ESG when relevant new information is available or at least annually.

[33] EBA, 2021, *The EBA Methodological Guide to Mystery Shopping*

Q25: How do firms ensure the consistency of the investment advice or portfolio management service provided when conducting suitability assessment with respect to the sustainability preferences expressed by a group of natural persons when no representative has been designated?

No response – 2DII has no evidence in relation to this.

Q26: What approach and criteria have firms adopted for the mapping of products' ESG features in view of their matching with clients' sustainability preferences?

2DII has no direct evidence in relation to this, however, we would make the following points.

Category A, B and C of sustainability preferences do not mirror the three categories of financial product established in the SFDR. Therefore it is not possible to develop a protocol which matches categories of financial product established in the SFDR to categories of client sustainability preferences which is universally applicable. Our best practice Guidance and Questionnaire recommends that investment firms should adopt a precautionary approach and assess financial instruments against categories of client sustainability preferences and wider sustainability motivations separately to categorising the same financial instruments under SFDR for disclosure purposes.[34]

However, in view of the broader concerns about misuse of the SFDR (see for example, ESMA's *Progress Report on Greenwashing* which articulates that even though SFDR is a disclosure regulation, the market has been using SFDR as a labelling regime) we consider that this is a key area where investment firms may not have a full adherence to the regulatory requirements.

Q27: How do firms apply sustainability-related concepts of Taxonomy Regulation and SFDR to MiFID II financial instruments that are outside the scope of SFDR (e.g., shares, bonds, certificates, etc.)? How do firms apply the "minimum proportion" concept to such instruments? In particular, how is the "minimum proportion" calculated?

No response – 2DII has no direct evidence in relation to this.

Q28: Are firms making use of ESG rating/scoring systems for products mapping in terms of sustainability? If yes, please provide details.

No response – 2DII has no direct evidence in relation to this.

Q29: In case of a positive reply to Q28, how do these interrelate with information gathered from manufacturers (or other sources)?

No response – 2DII has no direct evidence in relation to this.

Q30: How are firms, in their capacity as manufacturers and/or distributors, defining the target market for products with sustainability-related objectives, in terms of granularity? Please specify the elements that are defined for this purpose. Do firms adopt one single approach for all products, irrespective of whether they are in scope of SFDR? In case approaches differ, please explain why and how.

No response – 2DII has no direct evidence in relation to this.

Q31: What are the factors that firms, in their capacity as manufacturers and/or distributors, would consider for the periodic product reviews with respect to sustainability-related objectives?

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[34] The same logic should be applied to financial products with a sustainability label - all labelled financial products should be assessed against the categories of client sustainability preferences.

No response – 2DII has no direct evidence in relation to this

Q32: How are firms, in their capacity as distributors, collecting relevant information from manufactures on sustainability-related objectives of the target market? Is the information received from manufacturers sufficient, or are firms considering other inputs? If so, please explain why and describe such additional inputs.

2DII was part of the Findatex working group which developed the first version of the European ESG EET data template which is used for systematic and structured data exchange between product manufacturers and distributors.[35] Various data fields in the ESG EET data template are mandatory to comply with minimum requirements under SFDR and MiFID II/IDD, while other data fields are optional (since they are not explicitly referred to in regulation) but the working group (especially the distributors) considered this information to be relevant.

Considering end client demand, we consider that additional information on specific sustainability themes or SDGs or exclusion criteria are critical to increase transparency and protect end-clients (as targeted in SFDR and MiFID II). Therefore, these optional data points should be made mandatory to increase the level of transparency between product manufacturers and distributors and enable better exchange of information between distributors and end-clients.

Information on “sustainable investment“

Currently, a product manufacturer is expected to report on the proportion of sustainable investment for an Art. 8 or 9 fund if the criteria of “sustainable investment” applies (see data number 27 and 40-48 in the ESG EET data template). However, the manufacturer is not obliged to provide any details on the specific focus of the sustainable investment, although the information would be easily available (data numbers 49-53 are all optional). Based on preliminary research we consider that most financial products referring to “sustainable investment” do not provide enough level of detail to understand whether only one sustainability topic or various sustainability topics are considered. Yet, the number of sustainability topics integrated in an investment decision can have a high influence on the investable universe and is therefore a very important piece of information for the product distributor and end-client.

Information on “exclusion”

In the same vein, limited information on the scope of exclusion criteria (i.e. thresholds and scope of value chain) is another transparency issue which implies a high risk of misleading end-clients (e.g. if marketing documents suggest that certain topics are fully excluded while only a specific level of the value chain is actually excluded). Based on our exchanges with financial institutions in Germany and France in the context of our MyFairMoney fund product database over the last years, we observe a generally low level of transparency on exclusion definitions in the market (although we acknowledge improvement of some institutions we were in contact with). 2DII emphasised in the Findatex working group that exclusion criteria beyond the sustainability topics mentioned in SFDR and MiFID II are very relevant for a large number of end-clients and therefore should be integrated in the ESG EET data template to achieve higher transparency.[36] The product distributors endorsed our assessment so that the further exclusion criteria were integrated in the template (see data numbers 461-575) as optional data fields. Further reviews are needed to assess the level of transparency on exclusion definitions between product manufacturers and distributors and exchange of information between distributors and end-clients improves.

Information on “principal adverse impacts“

[35] See findatex.eu
[36] See our research findings on end-client preferences: 2DII, 2023, *6 National Country Reports*; 2DII, 2022, *Jumping the barriers to sustainable retail investment in France;* 2DII, 2022, *What do your clients actually want? Understanding and estimating household demand for sustainable financial products*

While principal adverse impact (PAI) indicators are included in the ESG EET template (see data numbers 105-220), the strategy for how PAIs are considered by an asset manager is not currently part of the ESG EET data template. One strategy linked to PAI consideration is investor engagement, which is a key strategy for impact-oriented retail clients. For now, there are only two data fields related to engagement/stewardship (data numbers 21 and 22) in the ESG EET data template. These data fields include information on stewardship codes which may have been adopted and an internet address where the client is supposed to find all relevant information regarding stewardship.[37] So far, the SRD II also does not require to include any information on the engagement or voting on sustainability issues and no minimum requirements for the quality of stewardship or the reporting on sustainability exists. This indicates that the data exchange between product manufacturers and distributors (about product manufacturer stewardship to reduce negative adverse impact) is inadequate. At the same time, research from InfluenceMap and ShareAction on the engagement and voting performance of the world's largest asset managers indicates that only a small share of public market funds managed by asset managers have credible and impactful engagement and voting performances.[38] These findings indicate a serious risk of misleading advice across Europe to (impact-oriented) clients who fall under sustainability preference category C and who want to use stewardship strategies to reduce the negative impact of the companies in their portfolio.

Hence, more structured, and detailed disclosures on sustainability-related engagement and voting is key to assessing impact related engagement claims in the future. This is especially relevant in the context of the consideration of Principal Adverse Impacts (PAIs) by using investor engagement (as referred to in the SFDR reporting template and the definition of sustainability preferences (category c)). While an amendment of SRD II can lead to improved disclosure on sustainability related stewardship, clear guidance or a European sustainable stewardship code for sustainability related stewardship is necessary to address this issue. In fact, Asset managers with credible and effective stewardship activities would likely benefit from such market standards since it would reveal free riding behaviour from competitors with uncredible and ineffective stewardship activities and would address green/impact washing risks for retail investors.

Do no significant harm

Any sustainable investment and therefore Art 9 funds needs to respect the principle of 'do no significant harm' (DNSH) referred to in point (17) of Article 2 of Regulation (EU) 2019/2088. The share of investments in investee companies that have been involved in violations of the *UN Global Compact* principles or *OECD Guidelines for Multinational Enterprises* and the share of investments in investee companies without policies to monitor compliance to those frameworks should be disclosed by these funds (see data numbers 201-208). However, there is no further regulatory clarification on the threshold for what constitutes significant harm or a violation of UN Global Compact or OECD Guidelines for Multinational Enterprises and no further information required from the product manufacturers on their approach. Given that methodologies of ESG rating agencies on UN Global Compact violations (especially thresholds for severe violations) varies significantly, we observe a high heterogeneity in approaches to what may be labelled compliance with DNSH. However, end clients will expect an exclusion of companies which violated for instance international Human Rights or Labour Rights principles (see also our response on question 22). There is a high risk of misleading communication and advice on DNSH where the DNSH approach and violation thresholds is not made transparent and understandable to end clients. To address greenwashing practices related to DNSH, the ESAs could recommend developing a standard framework to assess significant harm and violations of UN Global Compact or OECD Guidelines for Multinational Enterprises which can be used as standard by ESG rating agencies. Alternatively, the ESAs could recommend publishing a blacklist of companies which either fail to report on their due diligence duties or were involved in significant harm and violations of UN Global Compact or OECD Guidelines for Multinational Enterprises.

Q33: How are firms, in their capacity as manufacturers and/or distributors, treating products that do not consider sustainability factors in their product governance processes, specifically concerning the

[37] See findatex.eu

[38] See Influence Map, 2023, Asset Managers & Climate Change 2023 and ShareAction, 2023, Point of No Returns 2023

target market assessment related to the sustainability-related objectives (e.g. are sustainability-objectives considered in the negative target market assessment for such products? If so, please explain how).

No response – 2DII has no direct evidence in relation to this.

Q34: Have firms noticed increased demand by clients of financial instruments with sustainability features? Please provide any relevant available statistics on this topic (e.g. percentage of clients asking information about these products; trends over time). Furthermore, please explain if factors such as age, gender, level of education or level of income/wealth play a role in the demand for financial instruments with sustainability features.

Evidence pointing to the increasing importance of sustainability considerations in client investment decisions continues to grow.[39] Our most recent consumer research documents retail client beliefs and preferences regarding sustainable financial products in six Member States: Belgium, Italy, Netherlands, Poland, Spain and Sweden[40] and adds to our already extensive body of evidence on this topic.

At the same time, various anecdotal evidence is also available from certain investment firms that when they ask their clients about sustainability preferences during the suitability assessment, then many clients say they do not in fact have sustainability preferences.

While these two positions are clearly contradictory, we consider that the anecdotal evidence from certain investment firms points more to problems with:

- a complicated process being articulated for the assessment of sustainability preferences (in particular, the regulatory definition of sustainability preferences is complicated and involves concepts (taxonomy, sustainable investment, principal adverse impacts etc.) which will be new to many clients, clients will have varying levels of financial literacy and knowledge in sustainability issues etc.); and
- poor market practice in terms of compliance with the new requirements for the assessment of client sustainability preferences.

If client preferences for sustainable investment are analysed in a holistic sense (rather than viewed through the lens of sustainability preferences and the process articulated in the delegated regulation) then the data shows a clear increased demand by clients for financial instruments with sustainability features.

We would also repeat the point made elsewhere in this response that the results raise questions as to whether record keeping by advisors is adequate.[41] This means that ESMA must exercise extreme caution when interpreting feedback to this question.

Q35: Which percentage of products in firms' offering have sustainability features? Please provide breakdowns and details, where available. Are retail clients satisfied with the availability of products with sustainability features (number, type, characteristics)?

Our most recent research in seven Member States: Belgium, Italy, Netherlands, Poland, Spain, Sweden and France[42] reveals a pervasive supply-demand mismatch for financial products with sustainability features.

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[39] See summary of third-party research in 2DII, 2020, *A Large Majority of Retail Clients Want to Invest Sustainably*

[40] See most recently: 2DII, 2023, *Moving the blockers of retail sustainable finance* (a series of six market reports which summarise quantitative and qualitative research (quantitative surveys, bilateral interviews, focus groups, mystery shopping visits and a desk-study of the Lipper fund database) on the current situation regarding demand, supply and distribution of sustainable retail investment products in six European countries: Spain, Italy, Netherlands, Sweden, Belgium and Poland); 2DII, 2022, *What do your clients actually want? Understanding and estimating household demand for sustainable financial products*

[41] Both in relation to the initial identification of sustainability preferences and whether the client decides to adapt its sustainability preference when the advisor is unable to recommend a financial product which matches sustainability preferences as originally expressed.

[42] See most recently: 2DII, 2023, *Moving the blockers of retail sustainable finance* (a series of six market reports which summarise quantitative and qualitative research (quantitative surveys, bilateral interviews, focus groups, mystery shopping visits and a desk-study of the Lipper fund database) on the current situation regarding demand, supply and distribution of sustainable retail investment products in

The supply-demand mismatch is especially massive for impact-oriented products. Overall, the supply of sustainable financial products does not match demand. Clearly the financial industry must innovate on multiple fronts to find ways to serve the diversity of client profiles and variability in client sustainability preferences. On the supply side there is an insufficient and highly concentrated offer, focusing on a few sustainable strategies only. Such a concentration does not reflect the heterogeneity of clients' preferences and does not respond to the needs of impact-motivated clients.

Despite continual improvement, the supply of sustainable financial products for retail clients is still insufficiently wide and diversified. By way of example, the proportion of mutual funds with no sustainability features far exceeds the proportion of clients with no sustainability preferences (or wider sustainability motivations). And when funds do have sustainability features, these are too often restricted to (negative, positive or thematic) screening of the investment universe.

But these screening strategies are not suitable for impact-oriented clients. As a result, impact-oriented clients currently suffer the most from the inadequate supply. These screening strategies consequently need to be enhanced or complemented with other sustainable financial strategies that are known to have a stronger impact potential (like engagement, financing of undersupplied segments, flexible financing, provision of non-financial support).[43]

In terms of retail client satisfaction with the suitability assessment, level of advisor sustainable finance knowledge and the financial product recommendation, our mystery shopping campaign reveals that many mystery shoppers did not reveal concerns in these areas. While at first glance this appears a positive result, we think the results could reveal something less comforting.

The fact that many mystery shoppers did not articulate concerns is inconsistent with other results gained from the mystery shopping campaign which reveal low levels of regulatory compliance generally (and low levels of compliance with constituent parts of regulatory procedure) and generally poor practice in relation to accommodating impact-oriented investment opportunities, specific environmental topics and avoiding harmful activities.

One would ordinarily infer from these other results that clients should not be satisfied – but it appears to be the case that this is not apparent to many clients themselves. Therefore this raises the question whether this is a situation of both client and advisor being *lost in the maze*. Whether it is in fact the case that advisors have low levels of knowledge (either in terms of knowledge and competence on key sustainable finance topics or in terms of what is required by the regulatory procedure for the assessment of sustainability preferences) but that clients do not themselves have sufficient knowledge to be in a position where the low advisor knowledge is noticeable and apparent to them.

Q36: Are firms facing specific issues related to data availability/data quality with respect to financial instruments with sustainability features? If yes, how are firms dealing with these issues?

Besides the issues mentioned in our response to Q33, there are particular transparency issues in relation to the impact features of financial products. 2DII has renewed its market research on environmental impact marketing claims this year.[44] Our findings reveal that around 40% of misleading claims of Art 8 and 9 retail funds were unclear (i.e. not false per se). Unclear environmental impact claims are misleading because they are not presented in a clear, specific, unambiguous and accurate manner. Those claims are usually general, and their accuracy cannot be judged based on the information provided or material evidence is missing.

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six European countries: Spain, Italy, Netherlands, Sweden, Belgium and Poland); 2DII, 2022, *Jumping the barriers to sustainable retail investment in France*; 2DII, 2022, *What do your clients actually want? Understanding and estimating household demand for sustainable financial products*

[43] For more information on the impact potential of different investor mechanisms including price signalling of screening or tilting strategies, see our discussion papers: 2DII, 2023, *The Impact Potential Assessment Framework (IPAF) for financial products.*

[44] See 2DII, 2023, *Market review of environmental impact claims of retail investment funds in Europe*

Relevant examples are when a fund is not claiming a direct or measurable impact but claiming to *contribute* to a sustainability objective without providing any scientific evidence as to how this contribution is causally related to the achievement to the sustainability objective. In other cases, funds referred to specific impact mechanisms to influence company behaviour (such as engagement and voting or providing capital to undersupplied markets) which are backed by scientific evidence as being able to impact company behaviour but there is no further information to substantiate their claim.[45]

Regarding the substantiation of unclear environmental impact claims, public disclosures on engagement and voting deserve specific attention. In all cases, public disclosures on engagement and voting were insufficient to assess whether a fund claims to "*achieve positive effects"* or to "*reduce negative impacts"* through stewardship can be substantiated or not. Hence, more structured and detailed disclosures on sustainability-related engagement and voting is key to assessing these claims in the future. This is especially relevant in the context of the consideration of principal adverse impacts (PAIs) by using investor engagement (as referred to in the SFDR reporting template and sustainability preferences category C). Clear guidance or a European sustainable stewardship code is necessary to address this issue. This would address green/impact washing risks for retail investors and at the same time asset managers with credible and effective stewardship activities would likely benefit from such market standards (since it would reveal free riding behaviour from competitors with uncredible and ineffective stewardship activities).

Thanks to funding from the European Commission and German and Swiss Governments, 2DII has conducted a novel market research in six countries (France, Germany, Sweden, Italy, Ireland and Switzerland) based on our new Impact Potential Assessment Framework (**IPAF**). The IPAF presents an assessment grid which was derived from existing scientific frameworks and can be used to assess the impact potential of various financial products. While we expect to publish the final results by the end of September, our analysis already shows that financial products with the highest impact potential for retail or qualified investors (i.e. primary market products such as Thematic PE/Private Debt/VC funds, Sustainability Loan funds, Thematic Equity Crowdfunding, Sustainability Loan funds, Social Impact Bond funds, Thematic Peer-To-Peer lending as well as sustainable saving accounts) insufficiently report impact relevant information.

Impact relevant information includes how exactly the financial product provides flexible capital to investees (e.g. provision of concessional funding conditions (rate, risk transfer, duration etc.)), impact-linked incentivization schemes, efforts to address funding difficulties of the investees (e.g. by offering tailored or innovative financial solutions), the capacity to influence investee decisions through active engagement and how important are the resources dedicated to active engagement by the fund or how significant the capacity of the product is to influence stakeholders (issuers or investors) by signalling its strategy (through price or non-price signalling).

Due to poor disclosure of impact relevant information, the average IPAF rating of the identified product universe is currently low (yet, we could still derive financial products which can be recommendable for impact-oriented investors). We consider that requiring disclosure of more impact relevant information should be part of the upcoming SFDR revision. This would enable a systematic and structured processing of financial products with higher impact potential and help product distributors to select financial products for impact-oriented clients.

[45] A helpful tool for financial institutions at least to better understand the impact potential of their financial products can be 2DII's "Impact Potential Assessment Framework (IPAF)" (see 2DII, 2023, The Impact Potential Assessment Framework)