SIFMA response to ESMA Consultation Paper regarding Guidelines on certain aspects of the MiFID II suitability requirements (ESMA35-43-2998)

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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.

SIFMA AMG agrees with the suggested approach of informing clients clearly and simply about the suitability assessment and its purpose, which is to enable the firm to act in the client's best interest by recommending suitable products or services to the client based on complete and accurate information. However, we have a number of important observations and requests for clarification in the final guidelines. Please see our responses below.

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.

SIFMA AMG generally agrees with the new supporting guideline as it is important that the client understands the concept of "sustainability preferences" (as well as the distinction between the different elements of the definition) so they can provide a comprehensive response to a firm's questions regarding their preferences, but also so that the firm can understand and reflect the client's sustainability preferences, to the extent possible, when providing that client with investment advice or portfolio management services, in accordance with the firm's obligation to act in the client's best interest.

However, SIFMA AMG believes that this imposes a very high degree of responsibility on firms to educate clients and notes the practical difficulties of avoiding "technical language" in this regard. In general, the term "technical language" is subjective and therefore different clients may have different views as to when a firm is using "technical language" in their interactions. More specifically, however, SIFMA AMG considers it an outright prohibition on use of technical terms to be unrealistic in this context, particularly since the different limbs of the "sustainability preferences" definition are underpinned by detailed qualitative and quantitative analysis. For example, in relation to explaining the first limb of the "sustainability preferences" definition, the criteria for an economic activity to qualify as "environmentally sustainable" (i.e. Taxonomy-aligned) under the Taxonomy Regulation, are inherently complex due to the nature of the activity-specific technical screening criteria. Moreover, the consideration of principal adverse impacts ("PAI") limb requires the firm to agree with the client relevant qualitative and quantitative criteria in order to demonstrate such consideration. This will be exceptionally difficult when, for example, discussing science-based, quantitative thresholds around greenhouse gas emissions levels. Accordingly, SIFMA AMG believes that applying a blanket prohibition on the use of "technical language" when explaining the concept of "sustainability preferences" is unrealistic and potentially undermines firms' ability to be clear and accurate with clients regarding the concept of "sustainability preferences" and what it means for their portfolios.

Q3. Do you agree with the suggested approach on the arrangements necessary to understand clients and specifically with how the guideline has been updated to take into account of the clients' sustainability preferences? Please also state the reasons for your answer. Are there other alternative approaches, beyond the one suggested in guideline 2, that you consider compliant with the MiFID II requirements and that ESMA should consider? Please provide examples and details.

SIFMA AMG does not agree that the suggested approach in guideline 2 to obtaining clients' sustainability preferences.

Firstly, we think the requirement for firms to obtain information from clients as to all of their "sustainability preferences", even where firms do not have any financial instruments included in their product range that would meet the client's sustainability preferences, is both inefficient and impractical. Our understanding of the proposed approach is that it is essentially requires firms to collect from clients detailed and potentially unrealistic sustainability preferences even if, in practice particularly given lack of available data (as discussed further below), firms are unlikely at present to be able to fulfil those specific preferences. Firms would then only upon being unable to meet the client's sustainability preferences in practice discuss adapting these preferences with clients. In our view, this gives rise to a risk that clients become frustrated and disengaged with the process. Accordingly, rather than prescribing the sequence firms must step through in order to obtain a client's preferences, we consider that it would be more beneficial – for all parties – for firms to be able to inform clients up front what the firm can offer in respect of sustainability preferences (i.e. in the form of a menu of available options), whilst acknowledging that this menu will not necessarily remain static and will, to the extent possible and subject to the availability and quality of underlying data, offer more granular options, and allow clients to consider the extent to which those options align with their ESG goals and priorities, or if a competitor offers a better range of products from this perspective.

In addition, we think that the requirement to get information from clients on all three limbs of the sustainability preferences definition in "sufficiently granular" detail to enable firms to apply them cumulatively or in different combinations is currently unworkable given the lack of readily available data in respect of each of the limbs. By way of example, whilst firms will have to ask clients about their preference for a proportion of Taxonomy-aligned investments, undertakings in-scope of Article 8 of the Taxonomy Regulation are only disclosing Taxonomy-eligibility data this year; we will not have information on Taxonomy alignment for non-financial undertakings until 2023 and for financial undertakings until 2024. Likewise, the indicators and metrics of PAIs set out in the SFDR RTS will only start being published by firms in mid-2023. This inflexibility in the guidance will, in our view, lead to many cases where firms have to revert to clients explaining that they cannot meet their detailed preferences which could ultimately impact client relationships and lead to apathy towards sustainable products.

Finally, SIFMA AMG would welcome acknowledgment from ESMA that clients should be able to contractually request certain ESG or sustainability-related characteristics for their portfolios contractually without these necessarily being considered a suitability assessment feature.

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

Please see our response to Question 3 above. SIFMA AMG do not necessarily believe that *further* guidance is required, but rather we think ESMA should endeavour to make its guidance more flexible and practical in light of the issues raised in our responses.

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?

As noted in our response to Question 3 above, we note that there are significant practical difficulties in applying the sustainability preferences definition cumulatively or in combination, particularly given the lack of available data in respect of each limb.

SIFMA AMG notes that the guidance, as currently drafted, is not clear as to what firms should do where there is a conflict between (1) a client's sustainability preferences and other aspects of suitability, such as the client's financial situation and investment objectives; and (2) separate aspects of the client's sustainability preferences (i.e. due to simultaneous or overlapping preferences).

In relation to (1), SIFMA AMG considers that the guidance should explicitly state that that where a client's sustainability preferences conflict with other aspects of suitability (e.g. the client's financial situation) sustainability preferences can be disregarded (particularly given the fact that consideration of sustainability preferences is stated in paragraph 79 of the draft guidance as being a "second step" in the suitability assessment). We would also welcome clarity from ESMA that firms have the flexibility to override a client's sustainability preferences where necessary to e.g. prioritise a client's overall return objective or where the application of such preferences may lead to a disproportionate concentration in the portfolio of particular asset classes/sectors, such that the manager may have to override them from a risk management and diversification perspective. Please also see our response to Question 10 below.

In relation to (2), SIFMA AMG notes that it would be helpful for the guidance to make clear that in the case of a conflict between different limbs of a client's simultaneous / overlapping preferences that a firm may agree up front with the client which limb to be prioritised or, if multiple limbs are relevant, whether the client has an order of preferences.

Q6. Do you agree with the proposed approach with regard to the assessment of ESG preferences in the case of portfolio approach? Are there alternative approaches that ESMA should consider? Please provide possible examples.

SIFMA AMG agrees that information on a client's sustainability preferences should be collected at the portfolio level where firms are providing portfolio management or investment advice with a portfolio approach.

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

SIFMA AMG agrees that firms should update client's sustainability preferences as part of the client ongoing relationship. However, in our view, the draft guidelines are unclear in that they indicate that for existing clients, information on sustainability preferences should be obtained at the next regular update of client information, <u>or</u> during the first meeting with the client / first provision of advice that occurs from 2 August 2022 (i.e. when the rules come into effect) – it is left ambiguous as to whether ESMA is suggesting that firms can choose either of these opportunities to obtain sustainability preferences, or whether this indicates that sustainability preferences should be obtained at the first provision of advice if that occurs prior to the next regular update of client information. If the latter, this represents a change from previous guidance (which stated that firms could wait until the next regular update only) and firms would likely have to undertake a sustainability preferences outreach with existing clients before the new requirements enter into force on 2 August 2022. SIFMA AMG therefore requests clarity on this point.

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.

SIFMA AMG agrees that it is important for firms to have in place the policies and procedures necessary to understand the characteristics of investment products, including any sustainability factors, to allow firms to recommend suitable investments and/or invest in suitable products on behalf of clients.

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.

SIFMA AMG generally agrees with the principle that firms should have robust and objective procedures, methodologies and tools in place to appropriately consider sustainability factors of investment products in order to ensure firms are able to recommend investments that are, to the extent possible, aligned with the client's sustainability preferences. However, as noted above, SIFMA AMG considers there are significant practical difficulties with ESMA's proposal (as detailed in Question 3).

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.

SIFMA AMG does not agree with the additional guidance as, in our view, it conflates sustainability preferences with binding suitability criteria. The draft guidelines clearly state that sustainability preferences should only be addressed as a secondary consideration once suitability has been assessed (i.e. in respect of the client's knowledge, financial situation and objectives). In light of the secondary characterisation of sustainability preferences – and indeed the fact that these are, by their very nature, merely preferences and not binding considerations – it does not seem proportionate or practical, particularly in the context of ad hoc investment advice, to require clients to adapt their sustainability preferences in order for a firm to make a recommendation to the client where all other elements of suitability are satisfied. We think there is a risk that if a firm providing ad hoc investment advice to a client has to consistently liaise with the client to adapt their preferences in order to make a recommendation, the client could perceive this process to be unduly onerous and opt instead to become "sustainability neutral" in order to mitigate the administrative burdens affecting on their mandate. Our view is that, particularly in the professional client context, it would be better to agree up front with the client that where sustainability preferences are at odds with other aspects of the suitability assessment then those preferences may be set aside. Firms could then report to clients on a regular basis on the extent to which their advice has diverged from the client's sustainability preferences and the client can at that point decide whether they want to adapt their sustainability preferences or not.

The draft guidelines also seem to be focused more on the steps required to be taken in order to provide ad hoc investment advice that does not align with the client's sustainability preferences; it is ambiguous when it comes to the provision of portfolio management services / ongoing advice with a portfolio approach. Our understanding in this context is that firms can agree sustainability preferences with the client when agreeing the mandate / investment strategy and monitor adherence to the client's sustainability preferences at the portfolio level, rather than on a trade-by-trade basis, and, where necessary due to consistent or significant divergence from the client's preferences, issue recommendations to the client at the next periodic update/review to consider adapting their preferences. It would nonetheless be helpful if the draft guidelines would clarify this point.

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.

Please see our response to question 10 above.

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.

As noted in question 10 above, SIFMA AMG disagrees with requirement to agree with clients to adapting their sustainability preferences before a trade can take place or recommendation can be given because sustainability preferences are non-binding secondary considerations; they do not have the same primacy as the suitability assessment. Moreover, we think that the requirement for clients to adapt sustainability preferences before trading is contrary to Recital (8) of Commission Delegated Regulation (EU) 2021/1253 which states that "*financial instruments that are not eligible for individual sustainability preferences* <u>*can still be recommended by investment firms*</u>*, but not as meeting individual sustainability preferences*". Therefore, we think the guidance should be revised to provide that firms do not have to agree adaptations with clients of their sustainability preferences prior to making a recommendation, but they should (as required by Recital (8)) make clear, if relevant, that the recommendation is not aligned with the individual client's sustainability preferences (at which point the client may, in their own discretion, decide not to follow the firm's recommendation).

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)?

SIFMA AMG reiterates the point raised in response to Question 3 above that the proposal in guideline 8 for firms to collect all information concerning sustainability preferences of clients and, only then, inform the client that they don't have products that meet those preferences and that they will need to consider adapting their preferences is both impractical and excessively time-consuming. SIFMA AMG believes that clients' best interests would be better served by allowing firms to be open and transparent with clients as to the products they can offer from a sustainability preferences perspective and allow the client to make a decision on that basis in accordance with their own ESG goals and priorities (i.e. to select one of the available options or to consider alternative providers of investment services whose offering more closely aligns with their preferences). As noted in our response to question 3 above, it should also be open to clients to agree certain ESG or sustainability-related characteristics for their portfolios contractually without these forming part of the suitability assessment. Ultimately, it should be for firms to decide, on the basis of feedback from clients, whether their product offering is sufficiently fulsome and competitive in this regard.

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.

SIFMA AMG agrees that clients who do not respond to the question whether they have sustainability preferences or responds in the negative should be treated as “sustainability-neutral”. It seems logical to us that firms should be able to recommend “sustainability-neutral” clients products both with and without sustainability-related features (provided those products are suitable for the relevant client). It is, however, important that where a sustainability-neutral client is invested in a range of sustainable products that regulators do not presume the client has sustainability preferences where they have not expressed any. Nevertheless, SIFMA AMG welcomes the flexibility of this guidance and does not believe it should be more prescriptive.

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.

SIFMA AMG considers the proposed approach to adapting sustainability preferences in the case of a portfolio approach to be quite unclear. Our understanding is that in the case of portfolio management and ongoing investment advisory mandates with a portfolio approach, firms can obtain the client’s sustainability preferences at the outset of the mandate (i.e. as part of the initial suitability assessment) and is not required to agree adaptations to sustainability preferences, where necessary, with a client on a trade-by-trade basis. Instead, firms should monitor the extent to which the client’s preferences are being met at a portfolio level and, if considered necessary by the firm if preferences are consistently not met, discuss and recommend possible adaptations to the client at the next periodic update. SIFMA AMG believes this approach is sensible, but would welcome further clarification in the guidance that this is ESMA’s intention.

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?

Please see our responses to Questions 10 and 12 above.

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

SIFMA AMG agrees with the amendment in supporting guideline 10.

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.

SIFMA AMG agrees that staff giving investment advice or information about financial instruments to clients should have the necessary knowledge and competence, including with respect to sustainability preferences (and accordingly should receive appropriate and regular training in this regard). SIFMA AMG would reiterate, however, that the obligation to explain sustainability preferences in “non-technical terms” is impractical, in recognition of the fact that “non-technical terms” is very subjective and, as is widely acknowledged in the industry, the different limbs of the “sustainability preferences” definition are complex and based on technical qualitative and quantitative criteria. SIFMA AMG believes that there is a risk that staff could, in an effort to simplify these difficult concepts, inadvertently mislead clients as to their meaning and impact on their mandates. Therefore, in our view, the outright prohibition on the use of “technical” language in this context should be removed.

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

SIFMA AMG agrees with the guidance provided on record-keeping and on the need to record adaptations to preferences in the suitability report. Nevertheless, SIFMA AMG would reiterate its serious concerns that the guidance to require clients to adapt their sustainability preferences in order to make a recommendation is contrary to the legal text of Commission Delegated Regulation (EU) 2021/1253. SIFMA AMG would strongly encourage ESMA to reconsider its approach. It should be made clear that sustainability preferences are not akin to binding investment guidelines and can be disregarded where the suitability of a financial instrument for the client is otherwise established.

We would also note that as the guidelines are unlikely to be finalised before the requirement to take account of clients’ sustainability preferences enters into force, firms will likely incur significant expenditure based on draft guidance in terms of building the systems and controls for data collection and record-keeping.

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.

Yes.

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

SIFMA AMG would reiterate that it is far from ideal for the revised suitability requirements to be implemented prior to ESMA’s guidance being finalised (as this creates a backdrop of uncertainty against which firms must implement these requirements). We believe there should consequently be a degree of understanding from regulators that building the required systems and controls should be done on a best efforts basis (particularly to the extent ESMA changes the guidelines in a way that impacts firms’ systems build projects in respect of these new requirements).

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

N/A.

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.

N/A.