12 April 2022

European Securities and Markets Authority
CS 60747
201-203 Rue de Bercy
75021 Paris

CONSULTATION ON GUIDELINES ON CERTAIN ASPECTS OF THE MIFID II SUITABILITY REQUIREMENTS

Dear Sir or Madam,

The European Financial Market Lawyers Group (EFMLG)[1] intends to foster the harmonization of laws and market practices in the EU and to facilitate the progress in the Capital Markets Union. From this perspective of our work we are hereby providing our comments on the ESMA guidelines on certain aspects of the MIFID II suitability requirements.

While we very much welcome the ultimate objective of the European legislator and of ESMA of promoting sustainable finance with a view to reaching the overall European Union environmental objectives, as a general remark, we would like to stress that the new regulation and proposed guidelines give rise to a number of inconsistencies, concerns and doubts which we believe will hinder its implementation. In this regard, we would like to take the opportunity to point out some of these concerns, especially those where clarifications of the authorities would be welcome in order to ensure a smooth and harmonized implementation of the new regulation in Europe.

1.- Necessary alignment of implementation timelines of ESG regulations

The introduction of the MiFID and Insurance Distribution Directive (IDD) amendments (by means, respectively, of Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 and of Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021) as well as the guidelines with regard thereto can only effectively contribute to the consolidation of a solid sustainability framework provided their implementation timeline is coherent with the timing of the ESG related reporting and disclosure regulations (see overview in annex).

Without ESG data there is a considerable risk that only a limited number of products which can potentially meet the client's sustainability preferences will be available. Moreover, initially, those data will mainly (or even

[1] The European Financial Market Lawyers Group is a group of senior legal experts from the EU banking sector dedicated to making analysis and undertaking initiatives intended to foster the harmonization of laws and market practices and facilitate the integration of financial markets in Europe. The members of the Group are selected amongst lawyers of major credit institutions based in the EU active in the European financial markets. The Group is hosted by the Legal Services of the European Central Bank.

solely) consist of estimates (quantitative data on EU Taxonomy will only become available starting as of January 2023).

Together with i) the fact there is not (yet) any common understanding on the definition of "sustainable investment" (which is relevant for determining the client's sustainability preferences) or on how to consider principal adverse impacts as well as ii) the highly technical nature of the relevant regulatory concepts, the lack of reliable data will increase the risk i) of the financial sector being accused of greenwashing (cfr. the significant divergencies in estimations between data providers) and of ii) the entailed legal liabilities.

Conclusively, instead of clients being guided towards more sustainable investing, in practice, there is the risk that both the clients and financial institutions financial sector - being overwhelmed by the complexity of the subject and disappointed because high expectations cannot be met, - may turn their back to sustainable products whilst financial institutions still incur reputational and compliance risks.

We therefore urge to postpone the application date of the ESG MiFID and ESG IDD regulatory framework, preferably until 2024, giving the financial industry the time to collect and process the ESG data that are gradually becoming available, put their processes conveniently in place and educate their clients on sustainable investing.

In principle, such a postponement may seem contrary to the climate emergency but, in fact, the postponement will serve the environmental objectives of the EU including climate change because it will allow to use actual quantitative data on EU Taxonomy, which, as we say, will only become available starting as of 1 January 2023.

2.- Implementation of a "one-size fits all" approach and lack of clarity with respect to certain requirements

Delegated Regulation 2021/1253 and ESMA's suggested approach seem to adopt a "one-size fits all" approach and, therefore, do not take into account the different nature and characteristics of:

(a) certain financial instruments which are not under the scope of SFDR and Taxonomy Regulations; and

(b) the investment service provided to the client.

(a) With regards to **certain financial instruments which are not "financial products" under SFDR Regulation**. - In its consultation paper ESMA recognises the different product scope of MiFID II, the SFDR and the Taxonomy Regulation, however it states that *the definition of "sustainability preferences" "ensures that financial instruments with sustainability-related features are eligible for recommendation to the clients or potential clients who express sustainability preferences*".

In our opinion, since the scope of both aforementioned regulations is different to MIFID's scope ("*financial products"* vs. "*financial instruments*"), it becomes highly difficult or even impossible to meet the definition of sustainable investment (which is relevant for determining the client's sustainability preferences) in respect to certain MIFID II financial instruments.

For example, amongst others, this would be the case of derivative instruments concluded for hedging purposes where there is no investment by the client and the main objective of the client is to hedge its financial/commercial risks.

Therefore, the question arises as to how firms can i) correctly identify most of the financial instruments falling into the three categories envisaged in Delegated Regulation (EU) 2017/565 as amended by Delegated Regulation (EU) 2021/1253 and ii) possibly comply with the new rules in these cases and, more specifically, as to what extent it would make sense to ask the client for information on their sustainability preferences when the range of financial instruments that may be recommended, due to their own nature and characteristics, would hardly ever meet the definition of sustainability preferences. Clarification in this regard is essential. Otherwise we understand that the new framework could be, in practice, limiting the range of products that may be recommended to clients, so that, in general, a firm could only take into account in determining a client's sustainability preferences financial instruments which qualify as "financial products" under SFDR Regulation.

This would have major consequences with direct detrimental impact on the general EU policy goal of increasing/promoting products with sustainability features.

Furthermore, we believe that until this matter is clarified by the authorities, it would be convenient that supervisory action towards integration of sustainability preferences in respect of this kind of instruments (i.e. MIFID 2 financial instruments that do not fall under the scope of SFDR Regulation) is not prioritised.

(b) With regards to **the service provided to the client**.- ESMA's suggested approach seems to be very focused on portfolio management services and does not provide flexibility in order to adjust the sustainability preferences assessment in consideration of the type and scope of the service provided to the client. In this regard, MIFID II recognizes that investment firms may establish different approaches to the scope of investment advice they provide and that the advice may be based on a broad or a more restricted analysis of different types of financial instruments. For instance, a firm may provide an investment advice service which is addressed specifically to hedging the interest rate risk arising from the financial positions of clients by means of financial derivatives.

In this case, sustainability factors would not be relevant for the scope of the advice (thus, by their very nature, and as per paragraph (a) above, financial derivatives would hardly ever meet the definition of sustainability preferences included in MIFID II) and, therefore, we understand that it does not make much sense to integrate the sustainability preferences as part of the suitability assessment.

In these cases, we understand that it would be more useful and straightforward for the client to inform him/her from the very beginning that the investment advice provided will not address any sustainability preferences or, as the case may be, about the limitations of the service regarding the sustainability preferences assessment in consideration of the scope of the advice and the range of products covered. In fact, we understand that this approach would be perfectly aligned with:

articles 54.2 (*"Investment firms shall determine the extent of the information to be collected from clients in light of all the features of the investment advice or portfolio management services to be provided to those clients. Investment firms shall obtain from clients or potential clients* ***such information as is necessary*** *for the firm to understand the essential facts about the client and to have a reasonable basis for determining, giving due consideration to the nature and extent of the service provided….*")

and 54.5 ("T*he information about the investment objectives of the client or potential client shall include,* ***where relevant,*** *information about the length of time for which the client wishes to hold the investment, his or her preferences regarding risk taking, his or her risk tolerance, the purpose of the investment and in addition his or her sustainability preferences*") of MIFID II Delegated Regulation which foresee the **possibility of adapting the information to be obtained from the client within the suitability assessment depending on the scope of the service provided**.

3.- Excessive complexity on the integration of sustainability preferences in the advisory process

In our opinion, ESMA's suggested approach is excessively complex. It may even be considered unrealistic. Delegated Regulation 1253/2021 already introduces great complexity in order to integrate sustainability preferences in the advisory process (complex legal definitions cross-referenced to Taxonomy and SFDR concepts; concepts which seemingly overlap, at least partially, e.g. "sustainable investments" referenced to SFDR vs. "environmentally sustainable investments" referenced to Taxonomy, lack of clarity in respect of certain types of financial instruments, problems of data availability on the expected implementation timeline, etc.). With this background in mind, we believe that ESMA's approach should try to simplify a regime that is too complex in origin, especially from an investor/client perspective.

Furthermore, ESMA's suggested approach seems to assume that clients are familiar with the sustainability framework and have a proper understanding of the legal definition of sustainability preferences (as defined in the new article 2(7) of MIFID II Delegated Regulation as amended by Delegated Regulation (EU) 2021/1253), but this generally will not be the case (at least during a period of time following the implementation of this framework). In addition, as per the suggested approach, firms would have to provide clients with complex and technical explanations on still unclear concepts and ask them whether they have an interest in such concepts; without even being able to offer the respective products due to the initial unavailability of products meeting the sustainability preferences definition.

Moreover, pursuant to a fundamental principle enshrined in MiFID II, investment firms are already required – when providing information – to make sure that clients or potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis.

Furthermore, although Supporting Guideline 25 seems in general to be helpful by specifying the scope of the sustainability preference questionnaire, we would see the following issues, if the wording of the proposed questionnaire were interpreted narrowly: (i) the fourth bullet-point reaches beyond Art. 2 (7) Commission Delegated Regulation (EU) 2021/1253, insofar as instead of "qualitative **or** quantitative criteria" "qualitative **and** quantitative criteria" are foreseen; and (ii) the wording "sufficiently granular to allow for a matching of the client's sustainability preferences with the sustainability-related features of financial instruments" is problematic for firms when they face a client who does not have a clear view on its sustainability preferences at all.

Besides that, in respect of references to governance criteria, such as in the second bullet point of Supporting Guideline 26, firms are likely to face implementation difficulties as long as there is no harmonized definition for governance aspects of sustainability. Hence, taking into consideration governance criteria should be mandatory only once a common definition exists.

In our view, this scenario (which may be relatively frequent at least initially while the data remains unavailable and, therefore, the product offer is limited) could be confusing and frustrating for clients who will perceive that the advisory process is excessively complex, burdensome and time-consuming with no clear benefit for them. In fact, we believe that the suggested approach could ultimately result in clients losing interest in this kind of products due to the complexity of the process. Indeed, Supporting Guideline 26 i) admits that clients may express “generic” sustainability preferences and, in so doing, ii) seemingly points to the fact that ESMA is aware of the difficulties an average client may incur when providing highly technical indication regarding its sustainability objectives.

In view of the above, we propose a more flexible approach (both in terms of information to provide the client with and to obtain from the client in order to make the suitability assessment) that takes into account the scope of the service provided (in line with paragraph 2(b) above) and the availability of products potentially meeting clients’ sustainability preferences.

For instance, firms could inform clients from the very beginning about the range of available products with ESG features (with specific warnings about the lack of products with a certain range/proportion of sustainability preferences, where applicable) or could focus their explanations only in the category/ies for which the firm has products; and subsequently, ask the client about its sustainability preferences.

Regarding the particular questions on sustainability preferences, more flexibility should also be pursued or, at least, a more gradual implementation of the suggested approach should be considered (i.e. increasing granularity requirements at the same pace as sustainability data, legal certainty and availability of sustainable products/assets allows it). For instance, different questions could be included regarding the different kinds of sustainability preferences as per the suggested approach, but it also seems that in some cases, and for the time being, it could be less burdensome to include only one question that merges all the options set forth in paragraphs (a) to (c) of the definition of sustainability preferences or to directly ask the client whether he/she has specific sustainability preferences.

Thus, this option would definitely be easier from an investor perspective and would enable firms to introduce a more proportionate approach considering the type of clients concerned, the scope of the service provided and the range of available products. Firms would provide to their clients’ complete information on any limitations on their assessment of individual sustainability preferences and on any limitation or unavailability on the range of products available so that transparency towards the client is ensured. As a final remark, it is worth noticing that the case for flexibility is even more compelling in those cases where a “portfolio approach” is adopted (both in case of portfolio management as well as in case of portfolio advice).

For instance, it should be possible for a financial institution to average client portfolio. Not only is it more transparent for a client to be informed on the suitability of his or her portfolio as a whole, it would also bring the sustainability preferences as defined in MiFID in line with the disclosure requirements under SFDR where portfolio management is considered a Financial Product. Flexibility is also required where services are based on models and very granular individual preferences will not be met. In this respect, amending Supporting Guideline 27 would be advisable.

In conclusion, keeping the advisory process simple and flexible is essential in order to avoid unintended consequences. Otherwise, we believe that the introduction of complex explanations on the different limbs/options regarding the definition of sustainability preferences together with the initial lack of availability of products meeting these preferences may result in unintended consequences i.e.:

(a) clients being frustrated and confused and, therefore, losing interest in this kind of products (what could even result in clients stating that they have no sustainability preferences in order to speed up and simplify the process); and

(b) a reduction of the provision of investment advice services.

Without prejudice to the above, if ESMA's suggested approach was finally implemented as it currently is, then, we believe that ESMA should provide standard texts for the explanations to be provided to clients with regards to sustainability preferences and the different categories included in such a concept; or at least provide a set of minimum contents/information to be provided to clients as ESMA already did for debt financial instruments subject to the Bank Recovery and Resolution Directive 2.

This would contribute to reduce the confusion of clients as they would receive the exact same explanations regardless of the firm that provides them with the service and would also provide a safe harbor for firms, promoting a level playing field amongst Europe.

4.- Adjustment of sustainability preferences

We are concerned about ESMA's suggested approach regarding the necessary adjustment of the client's preferences in order to recommend a product that does not meet the client's original sustainability preferences. In our opinion, this approach is not aligned with Delegated Regulation 1253/2021 which expressly foresees the possibility of recommending a financial instrument that does not meet the client's sustainability preferences provided it is not recommended as meeting individual sustainability preferences.

Furthermore, as per art. 54.10 of MIFID II Delegated Regulation as amended by Delegated Regulation 1253/2021 and Recital 8 of Delegated Regulation 1253/2021, adjustment of the sustainability preferences is not established as a prior requirement for recommending a product that does not meet the client's sustainability preferences i.e. adjustment represents a possibility but not an obligation.

In particular, new paragraph 10 of art. 54 of MIFID II Delegated Regulation states that "*An investment firm shall not recommend financial instruments or decide to trade such instruments as meeting a client's or potential client's sustainability preferences when those financial instruments do not meet those preferences.* ***The investment firm shall explain to the client or potential clients the reasons for not doing so and keep records of those reasons****. Where no financial instrument meets the sustainability preferences of the client or potential client, and* ***the client decides*** *to adapt his or her sustainability preferences, the investment firm shall keep records of the decision of the client, including the reasons for that decision".*

What the aforementioned article does not state is that the client must necessarily adapt its preferences so that the firm can issue its recommendation. In fact, the aforementioned articles should be read in accordance with Recital 8 of Delegated Regulation 1253/2021 which expressly addresses this point: *It is necessary to* ***clarify that financial instruments that are not eligible for individual sustainability preferences can still be recommended*** *by investment firms, but not as meeting individual sustainability preferences.* ***In order to allow for further recommendations*** *to clients or potential clients, where financial instruments do not meet a client's sustainability preferences, the client* ***should have the possibility*** *to adapt information on his or her sustainability preferences.*

[2] Joint Statement of the EBA and ESMA on the treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive (https://www.esma.europa.eu/sites/default/files/library/esma71-99-991_eba_esma_statement_on_retail_holdings_of_bail-inable_debt.pdf).

In short, Recital 8 clarifies that a firm can still recommend a product which does not meet the client's sustainability preferences provided this fact is made clear to the client. In view of the above, if the client necessarily had to adapt its preferences (as suggested by ESMA) the specific case described in recital 8 where a firm recommends a financial instrument that is not eligible for individual sustainability preferences would simply never occur. Thus, the adaptation of client's sustainability preferences is an option/right that the client has in order to allow future/further recommendations. In our opinion, the key point which deserves particular attention in this respect is that investment firms must not present the relevant financial instrument as matching the individual sustainability preferences in such a way that materializes a greenwashing practice. This goal can be achieved through a specific information in the suitability report and not a mandatory adaptation of the client's sustainability preferences.

Without prejudice to the above, if ESMA's suggested approach was not amended, a number of practical problems would arise regarding the adaptation of client's sustainability preferences. In line with paragraphs 2 and 3 above, we believe that if the range of ESG financial instruments available within the advisory process is limited, it would not make sense to ask the client about theoretical sustainability preferences which probably will have to be adapted subsequently. In this regard, we believe that if a firm asks the client about its sustainability preferences (without providing information on available products), initially the client will likely ask for a big proportion of sustainability features. If subsequently, the firm has to explain that there are no products available with such ESG features, but with a lower percentage/range of sustainability features, the client will probably feel frustrated and confused and will find the process unnecessarily burdensome. Clients may even lose interest in this kind of products.

In addition, we cannot share ESMA's statement included in paragraph 81: "*With regards to the possibility for the client to adapt the sustainability preferences referred in Article 54(10) of the MIFID II Delegated Regulation, firms are reminded that this possibility should not be the standard procedure*". In our view, ESMA's suggested approach is not in line with Delegated Regulation 1253/2021 which expressly introduces the possibility for the client to adapt his/her sustainability preferences without further requirements except for the recordkeeping of such a decision. Furthermore, Recital 8 expressly recognises this possibility as a protection/right for the client: *"In order to allow for further recommendations to clients or potential clients, where financial instruments do not meet a client's sustainability preferences,* ***the client should have the possibility to adapt*** *information on his or her sustainability preferences"*.

In view of the above, we believe that ESMA's approach regarding the exceptionality of the adaptation of sustainability preferences of the client is not justified; specially where ESMA recognises that *"at this stage, the availability of financial instruments with sustainability features may be limited and the introduction of these financial instruments in the firm's product scope might be gradual"*.

To sum up, due to:

(i) the expected initial lack of availability of products potentially meeting sustainability preferences (as recognised by ESMA); and

(ii) the lack of knowledge of the clients on the sustainability framework and legal definitions, adjustment of sustainability preferences will probably be relatively frequent at least at an initial stage after implementation of the new framework. Thus, level 2 rules do not and should not restrict this possibility in any way.

Finally, we would like to highlight our concern over the restrictive effect on the passporting of financial products which could arise from diverging approaches by the competent authorities in the Member States to what constitutes a “sustainable product”. That is, **if a product classified as sustainable in a Member State is not directly granted the same status in every other jurisdiction the passporting of these sustainable products will be significantly hindered, and, therefore, in practice, the EU’s sustainable finance agenda will be delayed.**

Yours faithfully,

Fernando Conlledo Lantero

EFMLG

Vice-Chairman

Annex

Date	Regulatory changes - Application date	Impact
1 January 2022	Article 8 Taxonomy Delegated Act. – partially applicable	only quantitative reporting on the proportion of taxonomy eligible activities non-financial undertakings to disclose the proportion of Taxonomy-eligible economic activities. Limited disclosures by financial undertakings
2 August 2022	Application of the Delegated Regulation (EU) 2021/1253, Delegated Regulation (EU) 2021/1257	The suitability assessment will need to include the new sustainability preferences regime.
Q3-Q4 2022	Final ESMA guidelines?	
??	ESMA guidelines on product governance	Consultation has been announced
???	EIOPA guidelines	
22 November 2022	Application of the Delegated Directive (EU) 2021/1269	The target market will need to include any sustainability related objectives the financial instrument is compatible with + information on sustainability factors.
30 December 2022	Application of SFDR Article 7 (Transparency of adverse sustainability impacts at financial product level)	Updates needed to reflect the following: • Clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts • Statement that information on principal adverse impact is available in periodic reports In the preamble of the first draft MiFID amendment ((2020)2955205 the European Commission recognized the issue and stated that '[as of 30 December 2022], *investment firms should be able to increasingly recommend also those products as suitable in terms of client's sustainability preferences* *<u>after that date</u>*."
1 January 2023	Application of the SFDR RTS	Pre-contractual templates need to be added to existing pre-contractual documents. This will include the percentage of sustainable investments under

		SFDR and the disclosure of the percentage of the products´ Taxonomy alignment for Article 8 products with sustainable investments and all Article 9 SFDR products.
1 January 2023	Full application of the Article 8 Taxonomy DA to non-financial undertakings	First quantitative taxonomy reporting on taxonomy alignment for non-financial undertakings subject to NFRD for the 2022 reporting period. Before this date, no taxonomy data will be available on investee companies.
1 January 2024	Full application of the Article 8 Taxonomy DA to financial undertakings.	Financial undertakings falling under NFRD/CSRD start quantitatively reporting their entity taxonomy alignment levels (some information only as of 1 January 2026)
[financial years starting on or after 1 January 2023] [Listed SMEs three years later (1 January 2026)]	CSRD (still to be published)	[Sustainability Reporting Standards for SMEs at the latest by 31 October 2023]
?	Extension of taxonomy classification to (i) environmental objectives other than climate and climate change and (ii) social	