association of the luxembourg fund industry

Luxembourg, 27 April 2022

# Response to the ESMA consultation regarding Guidelines on certain aspects of the MiFID II suitability requirements

## Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the European Securities and Markets Authority for the opportunity to participate in this consultation regarding Guidelines on certain aspects of the MiFID II suitability requirements.

## Response to questions

### ***Guideline 1 – Information to clients about the purpose of the suitability assessment and its scope***

**Q1. Do you agree with the suggested approach on the information to clients about the purpose of the suitability assessment and its scope? Please also state the reasons for your answer.**

First of all, we would like to stress the difficulties raised by the misalignment of application dates of regulatory requirements as developed below.

The Delegated Regulation EU 2021/1253 underlying the update of the ESMA suitability Guidelines requires that for the distribution of a product as one that can meet sustainability preferences of a client, one or more of three specific criteria need to apply: (i) minimum proportion invested in sustainable investments (ii) minimum proportion invested in Taxonomy-aligned sustainable investments and (iii) the financial instrument considers Principal Adverse Impact (PAIs) on sustainability factors.

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*SFDR templates*

At this stage, we understand that the SFDR RTS as adopted by the EC containing the necessary information on (i) and (ii) will become applicable as from 1 January 2023, hence after the date of entry of application of the new requirements under MiFID II according to the Delegated Regulation on 2 August 2022.

*PAI consideration*

Similarly, the deadline for disclosing PAIs consideration at product level runs until December 2022.

*Taxonomy alignment*

The existing technical screening criteria currently available only cover a small subsection of the sustainability objectives and sustainable activities. Moreover, investee companies will only start reporting progressively Taxonomy alignment from 2023. As a result, for the time being, financial products can only show a very moderate level of Taxonomy alignment.

*Guidelines*

In addition, the updated ESMA Guidelines may not be finalized before the application date of the Delegated Regulation.

As the non-alignment of regulatory application dates triggers challenges/issues, a regulatory forbearance for the implementation of the updated Guidelines (e.g. until 2023) would be very much appreciated. A reasonable period of time must be foreseen for firms to implement the above requirements once the information is made available on the underlying investment products which firms may propose to their clients.

As another area of concern, we would like to highlight that there are currently data gaps and an incomplete methodology for defining the Taxonomy-alignment of investments. As a result, very few funds will be exhibiting a Taxonomy alignment in the near future. Investment firms should therefore be able to communicate the current / evolving market situation to the client, see our comment below under the response to Q2.

While we fully acknowledge the importance of matching products with investors' sustainability preferences in order to re-orient investments towards more sustainable technologies and businesses as well as the willingness of manufacturers to develop and distributors to offer such products, these current challenges cannot be disregarded. Accordingly, we suggest a pragmatic and flexible approach when asking clients about their sustainability preferences. Questions to the clients should neither be too prescriptive (and thereby too difficult to understand for retail clients), nor too open (and thereby leading to too many adaptations of preferences) and clients should be informed about the (yet increasing) availability of sustainable products. As another pragmatic approach, bucketing of certain levels of Taxonomy-alignment for available products could not only facilitate the understanding of the investor, but also help to establish a level-playing-field among jurisdictions.

In this context, we are also concerned that some NCAs are requesting thresholds (percentages) for sustainable investments. We believe that these practices go against the spirit of the SFDR and the Taxonomy Regulation and are putting under scrutiny the coherence of these Regulations as well as cross-border distribution while moving in the opposite direction from that of an EU Capital Market.

**Q2. Do you agree with the new supporting guideline in relation to the information to clients on the concept of sustainability preference or do you believe that the information requirement should be expanded further? Please also state the reasons for your answer.**

We generally agree with the new supporting guideline that should help clients to understand the concept of "sustainability preferences", the different types of products included under this term as well as the respective features, the choices to be made and also the current and evolving availability of the respective products (e.g. limited number of Taxonomy-aligned products, see above). However, we would like to stress the importance of flexibility when helping clients to understand the concept of "sustainability preferences". A suitable approach for the respective client should be possible. More sophisticated investors may be very well familiar with the legal terms used to describe sustainability preferences and their interconnectedness and would not need detailed explanations. Accordingly, we would propose the following addition to supporting guideline 16: *'In order to help clients understand the concept of "sustainability preferences" and the choices to be made in this context, firms should, <u>as appropriate and according to the client's knowledge</u>, explain the term and the distinction between the different elements of the definition of sustainability preferences under a) to c) […]'*While we appreciate that for many investors it may be difficult to understand the legal terminology and therefore suggest that flexibility should be provided, there should nonetheless be at some point a certain level of consistency in the approach regarding the manner in which questions are raised (e.g. to implement a sub-set of questions or indirect questions to ensure the client's understanding). However, we acknowledge that unfortunately the non-aligned timeline of the implementation of the updated ESMA Sustainability Guidelines and the regulation which the Guidelines are reflecting (MiFID Delegated Regulation EU 2021/1253, the SFDR and Taxonomy Regulation as well as their respective level 2 requirements and the NFRD respectively CSRD to come) renders such an aim very challenging to achieve in the short timeframe. But moving forward, as a medium-term objective, there should be a certain consistency regarding the manner in which questions are raised respectively in the language of the questions used.

## ***<u>Guideline 2 - arrangements necessary to understand clients</u>***

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

We understand that the level of information to be collected from clients should be granular enough to allow for a matching of the client's sustainability preferences with the sustainability-related features of the product. We are of the view that also the process of matching clients' sustainability preferences with products should provide for flexibility.

Many and very detailed questions may end up being too technical and difficult to understand, especially for retail clients, which could result in not arriving at an available, suitable product. For example, a possible decision for combinations of suitability preferences as mentioned under supporting guidelines 25, could lead to very technical considerations. A combination should therefore rather crystalize in the course of the assessment than to be inquired specifically.

In addition, there should be the possibility to reflect the current market circumstances and the products available and offered in order to be able to respond adequately to clients' expectations. I.e. the client should be informed at an early stage of the suitability assessment about the availability of matching products. Keeping in mind the current data gaps relevant for the assessment of sustainability preferences (e.g. non-financial undertakings only start disclosing the full KPIs on taxonomy-alignment under art. 8 Taxonomy Regulation Delegated Act as of January 2023), an early information of the client about the (still evolving) range of available products, could help to identify alternatives. While we fully acknowledge the importance of matching products with investors' sustainability preferences in order to re-orient investments towards more sustainable technologies and businesses as well as the willingness of manufacturers to develop and distributors to offer such products, it cannot be disregarded that due to the data gap and lack of methodologies to determine Taxonomy-alignment very few funds will be exhibiting a Taxonomy alignment in the near future. In ESMA's final advice on Article 8 of the Taxonomy Regulation of 26 February 2021 the estimated Taxonomy-alignment of EU fund equity and corporate bond holdings indicates that less than 3% of fund portfolios have an estimated Taxonomy-alignment of 5%, with the highest alignment in the 20-30% range, while a quarter of funds have 0% alignment. With this in mind, questions should not be asked too openly to the client on how much positive contribution to environmental objectives he/she would like to see in a product without providing additional information on available products. As the client will likely answer with a high number of contribution that is not available (yet), an open question without additional explanations may lead to frustration and a general loss of interest in investing by the client. Therefore, a pragmatic approach should be chosen in view of the existing regulation and implementation timelines. In this regard, bucketing of Taxonomy-alignment could not only help to facilitate the investors' understanding, but also be a way of establishing a level-playing field among jurisdictions. It should be noted that over time the market will have an increasing understanding of how the bucketing could be performed. Furthermore, the establishment of additional common principles or examples to enable a more encompassing and aligned definition of "sustainable investments" within the meaning of art. 2 (7) of the MiFID Delegated Regulation (EU) 2017/565 (referring to SFDR and Taxonomy Regulation) may further facilitate the exchanges with clients and subsequent investment decisions. It should be noted in this context that some NCAs are requesting thresholds (percentages) for sustainable investments. We believe that these practices go against the spirit of the SFDR and the Taxonomy Regulation and are putting under scrutiny the coherence of these Regulations as well as cross-border distribution while moving in the opposite direction from that of an EU Capital Market.

Informing clients at an early stage of the suitability assessment about the availability of matching products as well as the possibility to use bucketing, common principles or examples to define sustainable investments could eventually avoid the client (especially retail client) to become discouraged regarding investing which could ultimately hamper the intention under the renewed sustainable finance strategy to enable investors to re-orient investments towards more sustainable technologies and businesses. We would therefore suggest to consider these proposals under Guideline 2.

Furthermore, we appreciate the examples provided in the supporting guidelines on how to achieve a neutral and unbiased approach as to not influence clients' answers. Nonetheless, we would also here propose to clarify that more flexibility to the firms is granted and that there is no certain preferable way of sequencing questions over others while remaining the focus on the collection of the necessary client information.

Referring to our response under question 2, we would suggest to adapt the usage of legal terms to the respective client when assessing suitability preferences.

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

We do not believe that additional guidance is needed, but propose some clarifications and amendments.

The fourth bullet point under supporting guideline 26 could be amended. Under this bullet point it is stated that *"In case the client wishes to include a financial instrument that considers PAI, the information collected should cover the PAI and qualitative and quantitative elements mentioned under c)."* By contrast, the MiFID Delegated Regulation ((EU) 2021/1253) mentions under article 1 (1) amending art. 2 (7) of Delegated Regulation (EU) 2017/565 "*a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client […]".* We suggest to mirror this wording also under the said supporting guideline.

We would like to stress in this context that we welcome the flexibility contained in ESMA's proposal that firms could test the client's preferences and appetite for PAI integration with regard to the families of PAI indicators as a whole using the categories presented in the SFDR RTS instead of an approach based on each PAI indicator.

Referring to our suggestions under question 3 to leave room for further flexibilities in terms of information about available products in order not to discourage investments, we support ESMA's proposal under the third bullet point of supporting guideline 26. This proposal provides the possibility for firms to collect information on the client's preferences in terms of the "minimum proportion" of sustainable and Taxonomy-aligned environmentally sustainable investments by sufficiently granular ranges or sizes instead of particular percentages. We would nonetheless suggest to clarify that these ranges or sizes have not necessarily to be provided in percentages either as these may currently be still relatively low, keeping in mind the existing data gaps and at the moment partly still missing screening criteria (acknowledging that this is a work in progress). Displaying (at the moment evolving, but still relatively low) ranges/sizes of percentages may, again, discourage investors. By contrast, the description by the manufacturer to the distributor could be more granular (e.g. via the SFDR templates or the EET) in order for him/her to be in a position to explain to the client in an encompassing manner the possibilities at hand and to put these possibilities into context in view of the existing market circumstances (as mentioned in our response under question 3).

Moreover, we suggest to remove the notion of governance criteria from 2nd bullet point under Guideline 26 as governance aspects are a transversal concept that cannot be considered / focused upon on a stand-alone basis.

**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?**

Additional guidance may foresee that the client could be asked whether certain combinations are utmost relevance whereas other combinations may be "nice to have", but not necessarily hinder an investment decision in case a respective product is not available.

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

We generally agree with the proposed approach. However, we notice a discrepancy in the way the question is phrased (ESG preferences) compared to the suggestions in the Guidelines (referring to sustainability preferences as a different concept).

***<u>Guideline 5 - updating client information</u>***

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

We generally agree, but would suggest to include in this update information about newly available products that match the clients' sustainability preferences so that the evolving product ranges can be taken into account by the client and potentially also sustainability preferences be adapted accordingly.

***<u>Guideline 7 - arrangements necessary to understand investment products</u>***

**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.**

Referring to the amendments under 70 and 71 of the draft Guidelines, we generally agree with the proposed approach. A focus on sustainability preferences should be ensured when firms are adopting procedures, methodologies and tools that allow them to appropriately consider the different characteristics, including sustainability factors. Grouping of financial products when considering sustainability factors should take into consideration the current state of the market, be pragmatic in terms of having minimum ranges as they will be low in the first months, but will evolve. Furthermore, the Guidelines should allow the grouping of PAIs to be in practical categories.

**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.**

Subject to our response above, we consider the Guidelines to be sufficient at this time, so there is in our view no need for further development.

***<u>Guideline 8 - arrangements necessary to ensure the suitability of an investment</u>***

**Q10. Do you agree with the additional guidance provided regarding the arrangements necessary to ensure the suitability of an investment concerning the client's sustainability preferences?**

**Please also state the reasons for your answer.**

We generally agree, but would like to refer to our responses under question 3, the importance of providing flexibility and the evolving availability of potentially suitable products.

We would like to reiterate, referring to paragraph 81 of the draft Guidelines (stating that the possibility for the client to adapt the sustainability preferences should not be the standard procedure), that in view of the evolving product availability, there is the risk of ongoing adaptations of client preferences until a suitable product is found. Customers may find the process too cumbersome and end up in saying he/she has no sustainability preferences. One should be mindful not raise expectations of customers that are not realistic and pragmatic at this point in time.

**Q11. Do you agree with the approach outlined with regards to the situation where the firm can recommend a product that does not meet the client's preferences once the client has adapted such preferences? Do you believe that the guideline should be more detailed? Please also state the reasons for your answer.**

We do not believe that further guidance is needed, but would suggest to reconsider supporting Guideline 81. It states that the possibility for the client to adapt the sustainability preferences referred in Article 54 (10) of the MiFID II Delegated Regulation should not be the standard procedure. This stands in our view in contrast to article 1 (6) MiFID Delegated Regulation ((EU) 2021/1253) amending art. 54 (10) of Delegated Regulation (EU) 2017/565 which outlines specifically the possibility to adapt sustainability preferences. In addition, referring to our response under question 3, it may be necessary to adapt sustainability preferences as re-occurring procedure in order to be able to respond to clients' expectations while keeping in mind the current and evolving availability of products.

**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.**

We would like to refer to our response under question 11.

**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)?**

We would like to refer to our response under question 11 and 3.

**Q14. Do you agree with the proposed approach for firms to be adopted in the case where a client does not express sustainability preferences, or do you believe that the supporting guideline should be more prescriptive? Please also state the reasons for your answer.**

We believe that the supporting guideline is sufficiently prescriptive and agree with ESMA's proposal to establish a firm-internal approach when a client does not express sustainability preferences.

**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.**

N/A

**Q16. What measures do you believe that firms should implement to monitor situations where there is a significant occurrence of clients adapting their sustainability preferences? What type of initiatives do you envisage could be undertaken to address any issues detected as a result of this monitoring activity?**

We assume that in the first years of the implementation of the MiFID Delegated Regulation EU 2021/1253 and the updated ESMA suitability Guidelines, there will be a significant amount of adaptations of clients' sustainability preferences due to the current lack of available of products and yet incomplete methodologies to assess Taxonomy-alignment of investments (as mentioned in our answer to Q3). If questions to investors are too open or too prescriptive, there is the risk that no suitable (available) products can be offered despite the willingness of an Asset Manager to establish more Taxonomy-aligned products. On the positive side, it should be stressed that more activities will be covered by the Taxonomy going forward via the extended Taxonomy, the social Taxonomy as well as the technical screening criteria to determine the conditions under which activities qualify as contributing substantially to the remaining environmental objectives under article 9 (c) – (f) Taxonomy Regulation.

***<u>Guideline 10 - costs and benefits of switching investments</u>***

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

N/A

***<u>Guideline 11 - qualifications of firm staff</u>***

**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.**

As per the Delegated Acts MiFID firms will have to adapt their product governance process and integrate sustainability aspects into the product selection as well as conducting a regular review of the offering palette. In view of that, advisors should also be acquainted with / trained on the firm's product governance processes and how / why certain products have been selected for the advisory channel. This could have two main benefits:

- Credibility of the advisor as well as the products could be strengthened towards investors (and thus also strengthens the reputation and credibility of the selected AM`s);

- Firms would be (indirectly) asked to engage more with the AM's on the details of their ESG value proposition and thus enhance feedback loops to AM's on "areas for improvement" when they hear "what works with the client and what not".

***Guideline 12 - record-keeping***

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

We agree with the proposed guidelines.

***Other changes to the guidelines***

**Q20. Do you agree on the alignment of the two sets of guidelines (where common provisions exist for the assessment of suitability and appropriateness)? Please also state the reasons for your answer.**

N/A

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

We do not have any further comment or input on the draft guidelines.

***Good and bad practices***

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

We do not have any particular comment on the list of good and poor practices.

**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