Securities and Markets Stakeholder Group

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ADVICE TO ESMA

SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements.

I. Executive summary

The SMSG repeats its concerns about the level 1 sustainable finance legislation: complexity, timing, inconsistencies between different pieces of legislation (see Annex). There is a risk of misalignment of expectations of clients on the one hand and availability of products on the other hand. Also, the philosophy of confronting the client with a high number of indicators shifts the burden of interpretation towards the investor. Due to the highly quantitative approach, there is a risk that the potential role of engagement is disregarded and that the focus is on mere exclusion criteria and minimum proportions, while other approaches also have their merit.

For all these reasons, and assuming that this legislation will be on a learning path for a considerable period of time, the SMSG suggests that ESMA organizes an early *Call for Evidence* on how sustainability preferences are assessed and on possible alternative approaches. In this evaluation, it is important to place the "average"retail investor in the centre. Evidence of behavioral finance is in this case useful. To allow an integrated approach between different sets of legislation, the timing of this Call for Evidence is to be aligned with the scheduled review of the Sustainable Finance Disclosure Regulation. The SMSG also calls for a regular feedback process between financial markets participants, stakeholders in the wider sense, regulators and legislators.

While the SMSG agrees that green-washing should be avoided, it points at a possible reverse problem: green-bleaching, meaning fund managers that invest into sustainable activities but refrain from claiming so to avoid the data problems arising from the disclosure obligations. If green-bleaching is a more pervasive trend than anecdotical evidence indicates, that would make the current legislation partly irrelevant. Hence, the SMSG suggests that ESMA tries to collect, as part of the evaluation, information on this.

This "green-bleaching" may also be implicitly reflected in the viewpoints taken by the ESA's. For example, the ESAs suggest avoiding using estimates for taxonomy-aligned figures while rejecting the use of a disclaimer only (and asking for a hard figure, be it "0"). However, the real alignment is not "0".

While the level 1 legislation is outside the competence of ESMA and national regulators, regulators could, as neutral parties, prepare background information for media and the general public, in which the problem of data scarcity is highlighted, alongside general information (on what is to be understood by sustainability preferences, options a-c…).

Apart from these general remarks, the SMSG has some punctual remarks.

Requiring a client to indicate specific sustainability preferences (a, b or c), assumes that this client is a rational well-informed investor, which might not be the case. For this reason, it would be advisable that investors who have indicated that they do have sustainability preferences (by answering "Yes" on the starting question), are not obliged to indicate which specific preferences (a, b, c) they have, let alone indicate minimum proportions or approaches to Principal Adverse Impact indicators. The possibility not to indicate this does not negate the obligation of the advisor to present the three options to the client. Neither should the failure to indicate a specific option be interpreted as the investor not having sustainability preferences.

The SMSG is concerned about ESMA's suggestion that firms should assess a client's preference with regard to *combinations* of a, b and c. This can potentially result in such a wide range of alternatives that the client feels lost. Such a 'combination assessment' will at the very least necessitate measures to simplify the process for clients, for instance by means of default options or a table with products corresponding to each preference.

The Commission Delegated Regulation states, in referring to option c (consideration of principal adverse impact): "…where qualitative ***or*** quantitative elements demonstrating that consideration…". ESMA guideline 25 states: "…quantitative ***and*** qualitative criteria demonstrating that consideration." The SMSG suggests to align the guidelines with the Commission Delegated Regulation and use the word **'or'**.

The draft guidelines state that the adaptation of sustainability preferences should not be the standard procedure. Such a statement may lead to many misunderstandings, among other things because of the likely misalignment of expectations and availability of products. Hence, the SMSG deems it to be of crucial importance to add a clarification of what this means in the Guidelines, which reflects the current reality of a limited sustainable product offer and the need for the industry to adequately integrate the new rules in their IT-systems.

Also, without the client being informed about which products best proxy his/her initial preferences, there is a risk of an 'endless' iterative process of adapting sustainability preferences. This would be discouraging for the client. For this reason, it would be a good practice that, if after the first round of assessing sustainability preferences, it appears that none of the available products matches the client's initial preferences, the client is advised, prior to revising his/her preferences, about what the possible proxy investment products are. The guidelines should explicitly permit such interaction between the clients and the distributors. This is also important because if an end-situation appears where no products match a client's sustainability preferences and the client does not adapt his/her preferences, no recommendations can be made to the client, meaning that other suitability elements (such as risk profile) could also not be communicated to the client as part of a recommendation.

In case of ongoing relationships, sustainability preferences should be assessed at the next update of client information. The SMSG suggests reformulating this guideline so that sustainability preferences are not to be assessed at the first update of client information, but at the first investment advice meeting or similar.

In Annex, the SMSG also points at inconsistencies in the level 1 legislation. While this is outside the competency of ESMA, it reiterates the need for an evaluation of the legislation in which ESMA can be a leading actor.

I. General remarks

1. The legislation will be implemented in a context where several pieces of the puzzle are still missing. In particular, lack of data on investee companies will make the alignment of sustainability preferences and investment products difficult. In this context, it will be almost impossible for financial institutions to go beyond a 'best effort' compliance. This is neither appropriate nor desirable, but in the present context firms cannot be charged beyond best efforts with (i) the responsibility to make investors understand such a complex set of issues and (ii) completing the lack of regulation and data.

2. The lack of data makes it difficult for distributors and manufacturers to have investment products on offer with elevated proportions of Taxonomy alignment or sustainable investments or which consider Principal Adverse Impacts by using quantitative indicators. Clients are not aware of these problems. Hence, a mismatch between expectations of clients and the availability of products is likely and must be taken into account.

3. Even when data are available, their reliability is still questionable. The approval of the Corporate Sustainability Reporting Directive, its implementation, the proceedings of EFRAG are all crucial for reliable quantitative indicators.

4. The assessment of sustainability preferences is constrained by the Commission Delegated Regulation defining sustainability preferences. If guidelines were written from a blank sheet, the outcome would probably be different. Despite these constraints, the SMSG considers it useful that ESMA investigates alternatives ways to assess sustainability preferences, also taking into account insights from behavioral finance. (This is not only relevant for sustainability preferences, but for suitability assessment in general.)

5. The assessment of sustainability preferences entails some complex concepts and adds to the time required to answer a questionnaire. The underlying concepts, like the a, b, c options are not familiar themes for clients. There is no link with existing steps taken by funds in the field of sustainable finance, like the rules of a label or national -defined criteria. Neither the investor's ability to understand complex issues like this, nor the investor's willingness to spend time to a questionnaire is unlimited. As an overarching principle, rules should be focused on what is best for and of value to clients. It is important that information provided to clients can be understood, especially by retail clients, and that we avoid information overload. More flexibility could be accepted vis-à-vis professional clients.

6. Sustainable finance cannot be restricted to the use of mere exclusion criteria or the setting of minimum proportions. Other approaches, like a strong engagement, also in sectors or companies with a high adverse impact, best in class, and in general transition approaches have their merit. Due to the highly quantitative approach, for example with regard to Principal Adverse Impact, there is a risk that the potential role of engagement is disregarded.

7. As a general remark it is also important that guidelines that ESMA publishes are drafted in such a way that they help firms and clients, at the stage of the process they are at, even if that means that the guidelines may have to be updated at regular intervals. This would further help manage end-investors' expectations in terms of product availability.

8. The SMSG is aware that the implementation date of the Commission Delegated Regulation defining sustainability preferences (2 August 2022) is something that cannot be decided on by ESMA. Nevertheless, it wants to voice its concern that the timespan for implementation is too short, also taking into account the inconsistencies that still exist in the legislation (see Annex). Also, the SMSG seriously questions whether now is the right time for these changes to MiFID, taking into account that a broader revision of suitability and appropriateness procedures is being envisaged.

II. Question 1. 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.

9. It is important that clients understand the purpose of the suitability assessment in order to avoid that they consider it as a mere formalistic exercise. For this reason, the SMSG supports the guidelines about informing clients about purpose and scope of the suitability assessment. However, apart from the supporting guidelines about sustainability preferences, this approach has not been changed.

III. Question 2. 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.

10. The SMSG discussed whether it was desirable to inform the investors beforehand about the lack of data. As pro it was mentioned that providing the client with complete, clear and transparent information requires presenting all relevant elements of the context, including the lack of data. Also, informing the client beforehand could reduce the misalignment of expectations vs availability of products. As con it was mentioned that informing the client beforehand about the lack of data could influence him/her towards lowering his/her preferences. A side-effect could be to increase the acceptance of the current product range of the financial institution and remove the incentive of product distributors to increase the range of sustainable products in their product offer. While the SMSG discussed pro's and con's, it did not express a preference.

11. While the SMSG did not express a preference, it points at a trade-off between informing the client beforehand of the lack of data and the resulting limited offer, and the need to adapt preferences afterwards. The less the client is aware of the lack of data, the higher is the probability that his/her preferences will need to be adapted after the first round. The SMSG believes that the draft guidelines (pt 81), which state that adapting the preferences should not be the standard procedure, therefore need to be amended by adding a clarification of what this means, and reflecting the current reality of a limited sustainable product offer and the need for the industry to adequately integrate the new rules in their IT-systems.

12. Irrespective of the information given to the client, the core problem remains not so much a matter of language or of information, but the complexity of the concepts.

IV. Question 3. 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.

13. The concepts of this legislation are extremely complex and sometimes inconsistent (see Annex). They assume a rational, well-informed investor. For example: requiring a client to indicate specific sustainability preferences (a, b or c), assumes that this client is able to distinguish these options and prioritize them. Asking a client to indicate a preference for minimum proportions or to express how principal adverse impacts should be considered, assumes an extremely well-informed investor and also shifts the burden of interpretation to the client. It is as if asking an investor who has a preference for investments with high credit quality to define him/herself criteria with regard to cashflow, debt-to-assets ratio, debt to EBITDA….

14. For these reasons, the SMSG believes that investors, even if they have indicated to have sustainability preferences (by answering "Yes" on the starting question), should be offered the opportunity not to indicate which specific preferences (a, b, c) they have, let alone indicate minimum proportions or approaches to Principal Adverse Impact indicators. The SMSG believes that the opportunity not to indicate a preference for a, b or c is aligned with the Commission Delegated Regulation, provided:

    a. that the investor is presented the opportunity (but not the obligation) to indicate these preferences;

    b. that the failure to indicate to indicate a specific option, after (s)he has indicated to have sustainability preferences, should not be interpreted as the investor not having sustainability preferences.

15. It is likely that this legislation will evolve. For example, once the Taxonomy Regulation has defined Socially Sustainable Objectives, at least option a of the MiFID requirements will need to be reformulated, with possible spill-over effects to options b and c. The SMSG also points at the fact that the level 1 legislation schedules an evaluation moment of the Sustainable Finance Disclosure Regulation (SFDR), that could result in new legislative proposals. Article 19 of SFDR provides for an evaluation by 30 December 2022 including on *"whether the functioning of this Regulation is inhibited by the lack of data or their suboptimal quality, including indicators on adverse impacts on sustainability factors by investee companies."* While this review refers to SFDR, it could well impact on MiFID as well.

16. Financial markets participants, regulators and legislators will be on a learning curve in respect of this new legislation for a protracted timespan. Also, taking into account the scheduled review of at least the SFDR, *it is important that there is a feedback process between financial markets participants, stakeholders in the wider sense, regulators and legislators.* Also, *an early Call for Evidence* on how sustainability preferences are assessed and on possible alternative approaches is desirable. When considering the timing of the review, it is important that firms first get some time to implement and use the rules on a "best efforts" basis, to gain experiences that can then be taken into account in the review. To allow an integrated approach between different sets of legislation, the timing of this Call for Evidence is to be aligned with the scheduled review of SFDR. Although this is level 1 legislation and as such outside the competence of ESMA, the SMSG voices the concern that the scheduled evaluation of SFDR (31/12/2022) might come too early.

17. Right now, the approach to assess sustainability preferences is constrained by the options defined in the Commission Delegated Regulation on sustainability preferences. Nevertheless, the SMSG encourages ESMA to explore alternative ways of assessing sustainability preferences, also considering possible amendments to the Commission Delegated Regulation, and taking into account insights of amongst others behavioral finance.

V. Question 4 : Do you believe that further guidance is needed to clarify how firms should assess clients' sustainability preferences?

18. The wording of guideline 25 differs from the Commission Delegated Regulation defining sustainability preferences. Referring to Principal Adverse Impact, the Commission Delegated Regulation states: "a financial instrument that considers principal adverse impacts on sustainability factors where qualitative ***or*** quantitative elements demonstrating that consideration are determined by the client or potential client". ESMA guideline 25 states: "For aspect c), which principal adverse impacts (PAI) should be considered including quantitative ***and*** qualitative criteria demonstrating that consideration." It can be assumed that, especially in the upcoming years, there will be a lack of reliable quantitative Principal Adverse Impact indicators. Hence, the choice of wording, "and/or", is not merely semantic. The SMSG suggests to align the guidelines with the Commission Delegated Regulation (hence use the word **'or'**).

19. The wording of guideline 26 ("to achieve this, firms could choose the following approach") suggests that it is not-binding and mentioned as an example of a possible good approach. Given all uncertainties that at this moment still exist, the SMSG believes there is no single path to truth and does not believe that guidelines should be more prescriptive. Rather, the SMSG calls for distilling from possible different approaches best practices and repeats its insistence on an early Call for Evidence.

VI. Question 5: 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?

20. The draft guidelines (pt 25) suggest that a "combination assessment" should be part of the assessment: "Firms should collect the following information from clients: (…)Whether – and if so, to what extent - the client has sustainability preferences with regard to aspect a), b) or c) … and *if the client has a preference for, where relevant, a combination of one or more of the three aspects.*" Theoretically, this offers such a wide range of possibilities (12 combinations), that it is unworkable and will not be done.

    a. Client indicates none of the options (1)

    b. Client indicates one particular option (3)

    c. Client indicating all three, to be interpreted as a OR b OR c (1)

    d. Client indicating two options, to be interpreted as OR (a or b; a or c; b or c) (3)

    e. Client indicating all three, preferring a product that includes all three (a AND b AND c) (1)

    f. Client indicating two options, to be interpreted as AND (a AND b; a AND c; b AND c) (3)

21. If, nevertheless, such a "combination assessment" is used, it is imperative that this is combined with measures to enhance simplicity for clients. For example, a default option ("or") could be proposed. But instead of asking questions on combinations, the easiest solution would be to give clients a table with products corresponding to each preference. This gives clients the possibility to choose from the table the combination that suits them. In either case, the underlying concern remains that the "combination assessment" introduces too wide a range of possibilities, with as probable result that the client will feel lost.

22. Irrespective of whether or not the "combination assessment" is required, the SMSG's prime concern is transparency and clarity. A client who answers a questionnaire should know beforehand, i.e. before ticking the boxes, how the answers will be interpreted. If, for example, all options are selected, does that the mean that a product will be advised that is aligned with all these options (a AND b AND c), or a product that is aligned with a OR b OR c? The SMSG has a slight preference for the OR option. The reverse "AND" would reduce the range of available products even more.

VII. Question 6: 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.

VIII. Question 15: 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.

23. While the SMSG does not have specific comments with regard to the portfolio approach, its comments on the assessment of sustainability preferences are relevant in this context too.

IX. Question 7: Do you agree with the suggested approach on the topic of 'updating client information'? Please also state the reasons for your answer.

24. The draft guidelines (pt 55) state that for ongoing relationships, the information on sustainability preferences should be updated at the next regular update of client information. However, updating client information can be required for all kinds of purposes, for example "know your customer" requirements to prevent money laundering. It is not realistic to require that the first such instance should be accompanied by a complete renewed suitability assessment. To avoid misunderstandings, the SMSG suggests reformulating this guideline so that sustainability preferences are not to be assessed at the first update of client information, but at the first investment advice meeting.

X. Question 8: 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.

25. The SMSG has advised ESMA in the past that complexity is not a sliding scale in MiFID II. MiFID II distinguishes "complex" and "noncomplex" products. Hence, complexity has a clear and legally defined meaning. The SMSG has a general concern with the use of the concept "more complex products" in the Consultation Paper and does not agree with the introduction of a further classification of complex products according to lower and higher levels of complexity, unless clearly specified. A simple mention of "more complex" products leaves ground to heterogeneous interpretations to the detriment of investor protection. Although the reference to "more complex" is already present in the current guidelines, the SMSG advises ESMA to delete the distinction and, if ESMA is of the view that further distinction of product complexity is required, existing guidelines regarding complex products should be amended and updated accordingly.

XI. Question 9: 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.

26. Guideline 71 includes a requirement for consistency with MiFID Product Governance. While consistency with MiFID product governance is desirable, one must be careful not to introduce into MiFID product governance a level of detail for which it is not intended. For this reason, we suggest to add to the guidelines some words specifying that the consistency with MiFID product governance should not descend into too much detail. "Such grouping should also be **at a general level** consistent with the firm's analysis conducted for the purposes of product governance obligations.**"** Apart from this, the guidance is logical as it follows the structure and options distinguished for MiFID sustainability preferences.

XII. Question 10: 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.

27. The SMSG's is concerned about situations where clients express a wide sustainability preference at a stage where there is not yet a sufficient offer of matching products on the market. The SMSG's concerns are the following:

    a. It is likely that adapting client preferences will need to happen more often than not at this stage .

    b. Without information, the client will have no clue which products best proxy his/her initial preferences. An endless iterative adapting of sustainability preferences, which would be discouraging to the client, needs to be avoided.

    c. There is a risk that the absence of products that match a client's sustainability preferences, results in a prevalence of sustainability preferences over other suitability elements (such as risk profile), if the client does not adapt his/her sustainability preferences. In such a situation, the client would be left without advice at all. Such a situation is to be avoided.

    These concerns are commented on below.

XIII. Question 11: 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.

Question 12: 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.

Question 16: 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?

28. The SMSG repeats its fear that there will be, for a considerable amount of time, a serious mismatch between the expectations of investors and the availability of products. For this reason, the process of adapting sustainability preferences and the accompanying dialogue will probably be frequent and important in the initial phase of the implementation process. The draft guidelines (pt 81) state: "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". While the SMSG understands ESMA's concern that the initial preferences of the client should as a matter of principle be respected, and can only be adapted if the services provider has no way to comply with the specific client preferences, discussion in the SMSG showed that this statement could lead to many misunderstandings. Therefore, the SMSG deems it of crucial importance to also reflect in the Guidelines the current reality of a limited sustainable product offer and the need for the industry to adequately integrate the new rules in their IT-systems.

29. Hence, the SMSG strongly advises to add the following clarification to the statement that adapting sustainability preferences should not be the standard procedure: "*This means that adapting investor preferences should not be the default procedure. Nevertheless, the possibility for the investor to amend his/her sustainability preferences (as expressed initially) has been introduced by the regulator in order to enable the investor to have available a transaction in a product that is as closely aligned with his/her preferences as possible, rather than not being able to perform a transaction at all. ESMA understands*

that especially in the early stages of the implementation process, the product offer of sustainable products may be insufficient to match different investor profiles, and that adapting sustainability preferences may be frequently needed. Service providers should obviously also be allowed to integrate the technical possibility to amend the investor's sustainability preference in its relevant IT-flow. In general, it would be reasonable to expect to witness an inverse correlation between the incidence of amended sustainability preferences on the one hand, and the number and variety of sustainable investment products on offer in the market on the other hand.".

XIV. Question 13: 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)?

30. The SMSG repeats its concern that the lack of data will, certainly at this stage, result in a misalignment between expectations and availability of products. In order to avoid a second round of misalignment of expectations, it would be a good practice to inform the investor of the lack of data and its impact on the range of products that are available. Also, to avoid a new round of misalignment of expectations, it would be good that the client is informed at this stage about the range of products that are available and could be used as alternatives to his/her initial product expectations.

31. A particular concern is how the adaptation of sustainability preferences can be implemented in robo-advice, especially because of the short time-span to implement this legislation. In this respect, the SMSG repeats its suggestion for an early Call for Evidence and suggests that this is one of the issues to be looked into.

32. Without information on which products are the best alternatives to the client's initial preferences, there is a risk of an 'endless' iterative process of revising sustainability preferences. This could be discouraging for the client and lead to a wrong perception on the true availability of sustainable products, which could well have counterproductive consequences. For this reason, it would be a good practice that if, after the first round of assessing sustainability preferences, it appears that none of the available products matches the client's initial preferences, the client is advised, prior to revising his/her preferences, about what possible alternative investment products are. The guidelines should permit more interaction between clients and distributors, instead of imposing a self-assessment approach upon the client, who is unlikely to be well enough informed of the existing offer and of the options available to make a meaningful assessment.

XV. Question 14: 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?

33. The proposed approach is sufficient.

XVI. Question 17: Do you agree with the proposed amendment to supporting guideline 10? Please also state the reasons for your answer.

34. The proposed approach states: "when providing investment advice, a clear explanation of whether or not the benefits of the recommended switch are greater than its costs should be included in the

suitability report…". The SMSG assumes that this is intended as a general statement, but does not mean that specific quantitative calculations must be made. Also, non-quantitative elements may be relevant as well.

XVII. Question 18: 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.

35. The SMSG agrees with the proposed guidance and suggests that it be included in the ESMA guidelines for the assessment of knowledge and competence, so that there is one consolidated document on knowledge requirements.

36. While the SMSG agrees in principle with the additional guidance, it points at the extremely difficult timing. As the assessment of sustainability preferences is scheduled to start on 2 August 2022, the timespan for training will be extremely compressed. In this respect, the SMSG voices its concern. Training is of pivotal importance, to ensure an adequate between clients and advisors. However, taking into account the short timespan, the inconsistencies in the legislation, the piecemeal legislation… training will have to be organised in a context where there are still question marks from a conceptual point of view on how this legislation will have to be implemented. Also, there are practical concerns that may differ from member state to member state. For example, in member states with official training certification requirements, the procedure may require more time (which institutions can offer the training and the certification, will they be ready by 2 August, exams must be organized…)

XVIII. Question 19: Do you agree on the guidance provided on record keeping? Please also state the reasons for your answer?

37. The new MiFID requirements regarding sustainability preferences require that sustainability preferences are first assessed in a neutral way. Subsequently, when it turns out that client's preferences cannot be met, a dialogue between advisor and investor is envisaged, which could result in an adaptation of a client's preferences. To avoid later discussions, it is useful that the reason for this adaptation is recorded.

38. Also, the SMSG reiterates here its insistence on a feedback process between firms and regulators and an early call for evidence. For this, an overview of the frequency of and reasons for adaptation of preferences is useful.

39. The additional guidance on record keeping goes beyond sustainability preferences and also includes additional requirement on suitability, in particular to record *"the types of financial instruments that fit that profile and the rationale for such an assessment, as well as any changes and the reasons for them."* The SMSG notes that there are no legislative/regulatory standards on how a profile should be translated into types of financial instruments that fit that profile. This may result in divergent product offers for similar clients among different financial institutions. Hence, a record on the rationale is useful.

40. For all these reasons, the SMSG supports the guidance on record keeping.

XIX. Question 20: 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

41. Consistent regulation is important. As such, the SMSG agrees in principle with aligning the two sets of guidelines. However, at this stage it is not clear what this alignment will consist of. Hence, the SMSG's support is conditional.

XX. Question 21: Do you have any further comment or input on the draft guidelines?

42. The level 1 legislation is extremely complex and piecemeal engineered. There are instances of inconsistencies between level 1 legislation (see Annex) and there is only limited availability of data. Hence, there will probably be a considerable mismatch between the expectations of the investors and the availability of products. While the level 1 legislation is outside the competence of ESMA and national regulators, *regulators could, as neutral parties, prepare background information for media and the general public, in which the problem of data scarcity is also highlighted*. The SMSG would be positive to ESMA publishing general information for use by retail investors, for example about sustainability preferences and "a-c"-options that firms could refer to.

43. While avoiding green-washing is a necessity, there could also be a reverse problem: green-bleaching, meaning fund managers that invest in sustainable activities but refrain from claiming so to avoid the data problems arising from the disclosure obligations. While the SMSG does not have a comprehensive overview, anecdotical evidence suggests that this may be the case for example in private equity funds that have a fund of fund structure. These funds depend on the data disclosure of all the underlying funds. As these data are often not yet available, the fund itself cannot make sustainability disclosure and hence prefers not to make any sustainability claims. If green-bleaching is a more pervasive trend than anecdotical evidence indicates, that would make the current legislation partly irrelevant. For this reason, the SMSG suggests that ESMA tries to collect information on this, as part of an evaluation of the legislation.

44. This green-bleaching is also implicitly present in viewpoints of the ESA's. For example, the ESAs suggest to avoid estimates for taxonomy-aligned figures while rejecting the use of a disclaimer only (and asking for a hard figure, be it "0"). However, the real alignment is not "0".

45. There could be a conflict between suitability and sustainability preferences, in particular with regard to option a (Taxonomy alignment). Clients with a lower ability to bear loss, will usually be advised products with a higher proportion of government bonds (example mixed funds). As government bonds are not included in the methodology for Taxonomy Alignment, this would lower minimum proportions of Taxonomy Aligned investments (option a). It is not clear whether this would also be the case for option b (see Annex 1). This would not be the case if instruments that are not eligible for alignment with the Taxonomy Regulation are also excluded from the denominator, but that could raise the complexity of the legislation even more.

46. If no product matches a client's sustainability preferences and the client does not revise his/her preferences, no product can be recommended to the client. However, that would also mean that the client cannot be advised on other suitability elements (ability to bear loss, risk profile…). This prevalence of sustainable preferences over other suitability elements is not in the best interest of the client. For this reason, the SMSG considers it a good practice that if none of the available products matches the client's initial preferences, the client is advised, prior to revising his/her preferences, about possible alternative investment products. The guidelines should permit such interaction.

XXI. Question 22: Do you have any comment on the list of good and poor practices annexed to the guidelines?

47. It is useful that ESMA shares examples of good and poor practices. This would be even more so in the context of 'assessing sustainability preferences', where everyone is on a learning path. However, to avoid legal uncertainty and divergence between NCA's, it is important that ESMA classifies what status the examples of good and poor practices have, as compared to other 'soft rules', such as: Q & A's, opinions, recommendations…... If some NCA's consider 'poor practices' as a basis for sanctions, and others consider them as merely indicative, contextual or a starting point for dialogue, there would be regulatory divergence and legal uncertainty.

XXII. Question 23: 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.

48. The SMSG does not represent a particular institution. Hence, it is not possible to give information of the level of resources that are needed in relation to the nature, scale and complexity of activities. Apart from the costs already mentioned above, the SMSG also refers to the cost of data sourcing and to the time needed to assess sustainability preferences of a client. With regard to the latter, the SMSG warns of not overburdening the client, whose time is also valuable.

49. The SMSG repeats three concerns: (i) the timing is highly unrealistic; (ii) the adaptation of sustainability preferences may be feasible in a dialogue from person to person, but more difficult in a context of robo-advice (in particular given the short implementation time); (iii) training of staff is pivotal, but will need to take place in a very short timespan (see Q 18).

XXIII. ANNEX: an overview of inconsistencies between MiFID (the Commision Delegated Regulation defining sustainability preferences), Taxonomy Regulation and Sustainable Finance Disclosure Regulation.

50. Chronology of implementation: the disclosure obligations for investment companies and the obligations to assess sustainability preferences are scheduled ahead of the implementation of the revised MiFID II Product Governance rules and ahead of the obligations for investee companies on corporate sustainability disclosure. Even after the Corporate Sustainability Reporting Directive will be in place, the implementation of CSRD will require time. All this results in a limited availability of data.

51. Timing of SFDR vs MiFID:
    a. With Regulatory Technical Standards not having been delivered on time, the implementation of the Taxonomy Regulation and phase 2 of the SFDR and Taxonomy Regulation has been postponed to early 2023. However, sustainability preferences will need to be assessed from 2 August 2022 onwards.
    b. However, article 19 of SFDR provides for an evaluation by 30 December 2022, including "whether the functioning of this Regulation is inhibited by the lack of data or their suboptimal quality, including indicators on adverse impacts on sustainability factors by investee companies." This evaluation shall be accompanied, if appropriate, by a legislative proposal. This means that the full implementation of SFDR will start at the moment that it will be evaluated.

52. Inconsistencies between MiFID and SFDR: the level 1 legislator has desired to establish a category of products in between article 6 (no claims to ESG at all) and article 9 (fully sustainable objectives): the article 8 products. The sustainability preferences distinguished in MiFID do not always allow to distinguish these article 8 products from article 6 products. Although article 8 products promote environmental or social characteristics, it is not required that they: (a) have a minimum percentage taxonomy aligned investments, (b) have a minimum percentage of sustainable investments in terms of SFDR or (c) consider PAI. Hence, it is possible that they are not eligible for meeting sustainability preferences as defined under MiFID.

53. Inconsistencies between Taxonomy Regulation and SFDR:

a. The Taxonomy Regulation defines that the percentage of Taxonomy aligned investments in investee companies should be calculated based on turnover, Opex or Capex. No such definition is available for environmental or social objectives under SFDR. Should a similar calculation methodology be used or can both follow a different calculation methodology? Given that many companies have some degree of diversification, the range of companies that have 100% Taxonomy aligned activities in terms of turnover, Opex or Capex is restricted to niche companies. If a similar calculation methodology is to be followed, this would make it very difficult to have 100% sustainable investments in an investment product, which on its turn impacts the scope of art 9 products.
b. The Taxonomy Regulation describes, in a restrictive way, the instruments that are eligible for Taxonomy alignment. No such definitions are available for defining the proportion of sustainable investments under SFDR. Does this mean that for the calculation of minimum proportions under SFDR (option b), broader definitions can be used (relevant for example for Green and Social Bonds, and derivates like Carbon Contracts for Differences)?

54. Inconsistencies in the use of the words 'sustainable': in the SFDR, sustainable investments require environmental or social objectives; governance AND principal adverse impacts being considered. MiFID provides three options for sustainability preferences: alignment with Taxonomy Regulation; SFDR defined sustainable investments OR principal adverse impacts being considered.

55. Differences in the scope of MiFID vs SFDR: MiFID includes transferable securities. These are not in scope of the SFDR.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on

[signed]

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