



ESMA Final Report on the Guidelines on certain aspects of the MiFID II suitability requirements. International Bulletin of November 2022.

On 23 September 2022 the European Securities and Markets Authority (ESMA) published its Final Report on the Guidelines on certain aspects of MiFID II suitability requirements (the “Guidelines”).

The first Guidelines were published in 2012 with the aim of clarifying certain aspects of the MiFID suitability requirements. In 2018, after the adoption of MiFID II, they were revised to take account, among other things, of technological developments such as the increasing use of ‘robo-advice’ and to incorporate supervisory experience up to then.

On this occasion, ESMA has revised the 2018 text, considering 1) the adoption by the European Commission of the changes in Commission Delegated Regulation (EU) 2017/565 (the MiFID II Delegated Regulation) which requires investment firms to integrate sustainability factors¹, risk² and preferences³ into their organisational requirements and operating conditions; 2) the results of the 2020 Common Supervisory Action (CSA) conducted by national competent authorities to improve convergence⁴ and 3) the amendments made by the Capital Markets Recovery Package to Article 25(2) of MiFID II.

The proposed Guidelines were put to public consultation between January and April 2022. The Final Report summarises the responses received and how they have been taken into account. The Guidelines will apply six months after the publication of their translations into the official languages of the EU and then the 2018 version will no longer apply.

Main changes to the Guidelines

1. Introduction of the changes deriving from amendments to the Delegated Regulation

The 2018 version considered it good practice for firms to collect and analyse information on the sustainability preferences of clients or potential clients, but during the 2020 CSA it was observed that the majority of firms in the sample had not incorporated this into their suitability policies and procedures. The new Guidelines introduce the following changes:

Guideline 1. Information to clients about the purpose of the suitability assessment and its scope. As part of the suitability assessment, firms should help clients understand the concept of “sustainability preferences”, the different types of products included under that concept, as well as the characteristics and choices to be made in this context. It should be explained clearly, avoiding technical language.

Guideline 2. Collection of customer information on sustainability preferences. The information collected must include all aspects mentioned in the definition of sustainability preferences and must be granular enough to allow sustainability preferences to be matched to sustainability characteristics of financial instruments. When

collecting information, firms must follow a neutral and unbiased approach so as not to influence customer responses. Firms must collect information on: (1) whether the customer has sustainability preferences, (2) if so, whether they have preferences on one or more of aspects (a), (b) or (c) of the definition of sustainability preferences, (3) for aspects (a) and (b), the minimum proportion and (4) for aspect (c), which principal adverse impacts (PAIs) should be considered, indicating quantitative or qualitative criteria. To collect the minimum proportion, firms could help clients identify their minimum proportion using standardised minimums such as 20%, 25%, 30%, etc. Clients could also be asked whether for aspects (b) and (c) they prefer to focus more on environmental, social or governance factors, or on a combination of them, or even if whether they do not have such a focus.

In the case of PAIs, quantitative or qualitative information must be collected. One way could be to use the categories of indicators presented in the development of the Disclosure Regulation (such as, for example, greenhouse gas emissions, energy performance, water, waste, etc.) and, instead of asking indicator by indicator, checking the client's preferences regarding the families of indicators according to their possible focus on environmental, social or governance aspects. In this case, one could also ask whether the client would like to exclude certain economic activities from his or her investments.

Firms must guarantee the same level of granularity of the information collected when providing the portfolio management or investment advice service with a portfolio approach, for which reason they must ask clients what part or proportion of the portfolio, if any, they wish to be invested in products that meet sustainability preferences. In the case of model portfolios, firms should not carry out questionnaires that push the client towards a combination that does not meet his or her preferences.

Firms must have policies and instructions for staff dealing with customers when they state they have sustainability preferences but do not indicate a specific preference for any of the aspects (a) to (c) or with regard to the minimum proportion for aspects (a) and (b). In these cases firms could consider any of the aspects and should inform and explain to the client the sustainable characteristics of the products recommended or in which the firm will invest on the client's behalf and document in the suitability report the client's choice not to further specify the preferences. Firms should ensure that similar arrangements are in place when they provide robo-advice, given the limited human interaction.

Guideline 5. Updating of customer information. The information on the sustainability preferences of existing clients must be collected, at least, during the next periodic update of the client information that is carried out after the start of the application of the Delegated Regulation, that is, after 2 August 2022. However, customers will be able to update their information immediately if they wish. If immediate update is not requested, until the firm acquires information on the client's sustainability preferences, the client will be considered as "sustainability-neutral" and therefore the client could be recommended products both with and without sustainability-related features. ESMA expects firms to actively invite clients to update their profile regarding sustainability preferences within 12 months of the application of the Delegated Regulation.

Guideline 7. Understanding investment products. Firms' policies and procedures for understanding the characteristics and nature of investment products must take into account their sustainable factors. Likewise, when considering them to see whether they suit the preferences of clients, firms could, for example, group the financial instruments offered in terms of categories (a), (b) and (c). Such grouping could be consistent with the firm's analysis for meeting product governance obligations. In any case, this aggregation should not replace the collection of customer information.

Guideline 8. Ensuring the suitability of investments. Sustainability preferences will only be addressed within the suitability assessment process once the client's investment objective has been identified.

When firms cannot satisfy clients' sustainability preferences, they will let them know and clients will be able to adapt them, which will be duly documented.

In the case of investment advice the adaptation should be documented in the suitability report and monitored on a regular basis. In practice, this means that firms will not be able to recommend products that do not meet a customer's sustainability preferences unless the customer adapts these preferences and, only once the customer has expressed the intention of adapting these preferences can he or she be informed of the offer of products with sustainable characteristics. The adaptation should refer to the specific investment advice, not to the general profile of the client. This possibility of adaptation only refers to sustainability preferences, the product must meet the rest of the customer's suitability criteria.

In the case of portfolio management, when agreeing on the investment mandate and strategy, the client's sustainability preferences must be collected and evaluated. If the firm cannot comply with them, this should be discussed with the client who should be asked whether he or she wishes to change these preferences. The decision must be recorded in the mandate.

When providing investment advice with a portfolio approach, firms should assess the client's sustainability preferences and check whether or not these are met at the portfolio level and issue the appropriate recommendation.

In both the case of portfolio management and portfolio-focused investment advice, if the client adapts his or her sustainability preferences after the initial assessment, firms must assess the impact of this change and whether it requires rebalancing the portfolio.

If the client does not answer whether he or she has sustainability preferences or answers in the negative, the firm may consider that customer as neutral in terms of sustainability and recommend products both with and without sustainability characteristics.

Guideline 11. *Organisational requirements.* The staff that provide financial advice, or provide information on financial instruments, must have the necessary knowledge and competence and be able to explain different aspects to clients in non-technical terms, so firms should provide the appropriate training for this staff.

Guideline 12. *Record keeping.* Firms must keep records of their clients' sustainability preferences as well as any updates to them, including a clear explanation of the reasons for such change.

2. The capital markets recovery package

Guideline 10. To adjust the Guidelines to the amendment of Article 25(2) of MiFID II, the indication is added that when investment advice is provided, a clear explanation must be included in the suitability report that firms must provide to the retail client before carrying out the transaction as to whether or not the benefits of the recommended switch are greater than its costs.

3. Other changes to the Guidelines

Guideline 4. Regarding the evaluation of the client's knowledge and experience, questions aimed at evaluating real knowledge should be used and general questions avoided. When the firm fills in customer information based on its trading history, the customer must be able to review and correct that information.

The ESMA Guidelines relating to certain aspects of the suitability and execution-only requirements of MiFID II have been taken into account to ensure that similar requirements are treated in the same way, with minor editorial changes affecting Guidelines 1, 2 and 4.

4. Inclusion of a list of good practices and poor practices

To incorporate the results of the 2020 CSA, a list of observed good and poor practices has been included to provide some practical guidance to banks in areas where a lack of convergence appears to persist.

Good practices related to client profiling, costs and benefits of switching investments as well as indicators/monitoring/control functions have been identified.

Poor practices are found in relation to the client profiling, product mapping, matching and the costs and benefits of switching investments.

1 Sustainability factors are considered to be all information related to environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

2 A sustainability risk is any environmental, social or governance event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of an investment.

3 Article 2(7) of the MiFID II Delegated Regulation defines sustainability preferences as a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment: a) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in the Taxonomy Regulation; b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2(17) of the Disclosure Regulation; c) 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.

4 CSAs help national competent authorities and ESMA to assess convergence in the application of regulatory requirements by supervised firms, detect problems and establish measures. ESMA's public statement on this CSA can be found here:

https://www.esma.europa.eu/sites/default/files/library/esma35-43-2748_public_statement_on_2020_csa_on_suitability.pdf

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