

## **PIMFA position paper and response to the European Commission Sustainable Finance Initiative – MiFID II suitability requirements**

### **Introduction: about PIMFA**

The Personal Investment Management & Financial Advice Association (“PIMFA”) was created on 1 June 2017 by the merger between the Wealth Management Association (“WMA”) and the Association of Professional Financial Advisers (“APFA”). PIMFA’s members cover a broad spectrum of business offering investment management, personal financial advice and planning, and execution services to retail investors, and is the main UK organisation representing this sector. We represent the needs of our members to Regulators, Government and key stakeholders and serve to further the interests of our member firms, with a clear niche in the financial services sector, and our key specialisms include lobbying, policy work and representation.

### **Our response**

PIMFA welcomes this opportunity to provide feedback on the legislative proposals on Sustainable Finance following the European Commission’s Action Plan for Sustainable Growth launched in March 2018 and the HLEG recommendations in January 2018. In light of these recommendations, integrating ESG factors into financial advice and creating a new framework for sustainable finance are necessary to channel investments into sustainable activities.

We welcome the amendments to the delegated acts under MiFID II and IDD as a step towards developing the overall sustainability framework. In particular, it is encouraging to see these considerations taken into account in the recently published ESMA guidelines on suitability as they incorporate non-financial objectives as an example of good practice.

Some of the points we would like to highlight in our response are as follows:

- The draft text wrongly uses the term ‘the most suitable products’. This reference should be amended to reflect the obligations of investment firms more accurately.
- ESG considerations should not override existing suitability obligations.
- Some guidance or examples of good practice regarding the interaction of the firm’s duties towards clients, suitability and ESG considerations are needed.
- It would be useful to know the expectations as to existing clients and transitional arrangements for updating ESG preferences.

## Most suitable products vs suitable products

Recital 9 of the draft MiFID II delegated regulation says that “*to enable those investment firms to recommend the most suitable products to the client, investment firms providing investment advice and portfolio management should introduce questions in their suitability assessment that would help identify the client’s investment objectives, including ESG preference*”. The reference to ‘the most suitable’ products is incorrect and needs to be amended in order to reflect the obligations defined in article 25 of MiFID II.

The reference to ‘the most suitable products’ is concerning. The most recent suitability guidelines do not refer to this term – instead, they refer to ‘suitable products or services’, as reflected in the text of MiFID II. The reference to the “most suitable products” in the recitals is wrongly drafted and needs to be amended. This would be in line with the recently published ESMA final report on suitability guidelines<sup>1</sup> and the allusion to ‘suitable products or services’.

Therefore we would recommend the Commission to modify this Recital to reflect the current obligations as ‘suitable products or services’ in order to avoid putting unrealistic burdens on investment firms that are not in line with their MiFID II obligations. Amending the text in this respect will also help towards achieving consistency in the legislative proposals

## Questions in the suitability assessment

The draft text seems to incorporate some references to a questionnaire on ESG as part of the suitability assessment. For example, the text says that ‘*Article 1 of this Regulation aims at clarifying that investment firms (...) should carry out a mandatory assessment of ESG preferences of their clients in a questionnaire addressed to them*’. Similarly, Recital 9 addresses this by saying that investment firms should introduce questions to help identify investment objectives, including ESG preferences.

Our understanding is that the reference to introducing questions is considered to be part of the overall suitability assessment. We recognise that whilst the MiFID II text refers to a questionnaire as a way to comply with suitability obligations, it does not mandate for a formal questionnaire to be used at all times. Therefore requesting a questionnaire in the draft text would be inconsistent with the existing requirements in MiFID II.

This set of questions will be part of the overall KYC process and the sustainability considerations should not have preference over other suitability obligations. Perhaps it would be useful to slightly alter Recital 9 to say instead ‘*(...) Introduce questions as part of their suitability assessment...*’ or to modify the explanatory text where it mentions ‘a questionnaire’ for the avoidance of doubt.

## Incorporating ESG preferences: risks and costs

Article 1.5.c) of the draft delegated regulation refers to the need for firms to take into account the costs and complexity of financial instruments to fit into the client’s profile: “*Investment firms shall have in place, and be able to demonstrate, that they have in place adequate policies and*

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<sup>1</sup> Guidelines on certain aspects of the MiFID II suitability requirements, ESMA, May 2018  
<https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-mifid-ii-suitability-requirements>

*procedures to ensure that they understand the nature, features, including costs, risks of investment services, and financial instruments selected for their clients, including any environmental, social and governance considerations, and that they shall assess, while taking into account cost and complexity, whether equivalent investment services or financial instruments can meet their client's profile".*

With regards to risks and costs generally, we note that there may be some concerns in the overall suitability assessment as regards diversity in available ESG instruments. In particular, we would like to ensure homogeneity in the process of assessing suitability and in the process of integrating ESG considerations so that these instruments are considered in line with the rest of the instruments in the portfolio.

In addition to the costs and risks, Article 1.5 refers to adequate policies and procedures and the assessments of costs and complexity when incorporating ESG considerations. In this article, the draft text is unclear as to what obligations are placed on investment firms taking the decision to trade for clients and what the expectations are on the policies and procedures to have in place. In this sense, we believe there should be a reference in the text specifying that the ESG preferences should not over-ride the other suitability obligations.

Overall, we can see there may be some cases where firms may over-ride their overall suitability obligations in favour of incorporating ESG preferences. ESG considerations should be treated as one of the many inputs for the suitability assessment and they should have the same relevance/weight as other factors. Therefore it would be beneficial to make reference to this situation in the draft text to ensure proper implementation, ideally as part of Recital 9.

## **ESG preferences and taxonomy**

In order to incorporate client's preferences into their portfolio, a harmonised methodology for identifying any suitable ESG products will be necessary. The Commission has put forward proposals to facilitate the establishment of a framework to facilitate sustainable investment<sup>2</sup> and a part of the suitability process will be related to the taxonomy regulation and the consideration given to sustainable activities.

One concern firms currently face is how to make sure clients' money is allocated in the way they expected. The taxonomy regulation refers to the fact that the degree of sustainability can be determined for portfolios consisting of several companies by incentivising certain investments into sustainable activities without penalising investments into other economic activities.

For the avoidance of doubt and in order to understand the suitability obligations, we think the draft text of the MiFID II suitability requirements with regards to sustainable finance should make clear what the degree of flexibility is when determining the composition of the portfolio and the client's profile. We believe this would help firms understand that the judgement of ESG preferences will be in the same terms as the rest of the suitability preferences and not on a one-by-one basis.

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<sup>2</sup> Proposal for a Regulation of The European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-353\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-353_en)

## **Clients' preferences**

The proposed new article 54.2.a) introduces a reference to 'any preferences'. In particular, the new text says "(...) including the clients risk tolerance and any preferences, including environmental, social and governance considerations". The reference to 'any preferences' determines a new drafting and at first sight it appears to be a wider definition than the original one contained in article 52 of Directive 2017/566. It appears to introduce not just the ESG preferences but more widely any other preferences that the client may have.

This puts firms in a difficult position and we would ask the Commission to explain the intention of the text and the meaning of 'any preferences'. If the objective of the text is indeed to include any preferences other than ESG and therefore have a wider scope in the assessment of suitability and the suitability reports, we would like the Commission to ascertain what those obligations would look like.

In our view, the intention of the text is to include ESG as part of the investment objectives of the client, not to include any preferences other than ESG considerations. Therefore the reference in the draft text to 'any preferences' should be amended to reflect the appropriate obligations for firms. A proposed amendment could look like this: "(a) *it meets the investment objectives of the client in question, including the clients risk tolerance and any environmental, social and governance considerations*".

## **Existing clients**

The draft text is silent on transitional arrangements for existing clients and the process to follow for addressing the proposed ESG preferences. The implementation of the proposed text will result in firms spending a significant amount of their time applying new processes, arranging face-to-face meetings and an overall increased engagement with existing clients to inform them about their ESG preferences. This is particularly important for our sector.

For example, it would be useful for firms to know what the expectations are from the European Commission and ESMA regarding any potential repapering of contracts and the obligation to contact existing clients to update their ESG preferences, in particular given the tight timelines for implementation.

## **Good practice**

We welcome the recently published ESMA suitability guidelines in reference to the Commission's Action Plan on Financing Sustainable Growth. In particular, we are keen on ESMA's decision to include good practice for firms with regards to non-financial factors. Some good practice examples would also help in terms of putting into place the right policies and procedures to assess ESG preferences and would help advisors when making recommendations.

As a remark, we would encourage ESMA to publish consultation guidelines at the earliest opportunity to help member firms in developing their policies and objectives towards ESG investing.

## **Acting on the client's best interest**

There may be some concerns as to how to incorporate ESG considerations efficiently in order to avoid any future disputes regarding the firms' duties towards clients. This is particularly relevant in a situation where, for example, a client has positively selected a list of activities to be taken into consideration for his or her profile. A situation where the client has showed some interest in including certain ESG activities provides firms with more flexibility as these preferences will be just one of the factors to be taken into consideration. However, in a situation where the client actively excludes certain activities may be open to problems in the future.

More specifically, there may be a case where a client may want to invest in a specific ESG product even if this is not considered to be suitable by his or her advisor. As a result it would be difficult to assess the impact on firms in a situation where the product is not suitable yet the client has chosen to invest in it. We believe some examples of good practice on the interaction between the firm's duties towards clients, suitability and ESG would be of use to investment firms.

Generally, we note the difficulty in trying to allocate a portfolio in the way requested by the clients considering all these factors. The obligations and scope of the definitions are not sufficiently clear and this may hinder firms' disposition towards investing in ESG.

Overall, our expectations in this matter are that provided firms have transparent and record keeping policies in place explaining the process they use to invest in certain financial instruments; this should be enough to justify they were acting on their best endeavours with regards to ESG considerations. An unintended consequence of the proposals is that the scope of the obligations and the definitions prove to be unclear or too wide, and this may result in firms being driven away from investing in ESG.

However we believe that some reference in the text to this process and to the extent of the obligations would help firms feel confident and would encourage them to direct their efforts towards ESG investing.

## **Financial products vs financial instruments**

Recitals 10, 11 and 12 refer to financial instruments and financial products. However the obligations for distributors with regards to the assessment of sustainability in the context of financial instruments is not addressed in the text.

Recital 12 says "*Investment firms should also explain to the client how his or her ESG preferences for each financial instrument is taken into consideration in the selection process used by those firms to recommend financial products*". However the text is silent as to the obligations regarding assessment of financial instruments and what the obligations of distributors are in this respect. For example, we would be interested to know what happens in a situation where a firm is selling shares in the secondary market.

In our opinion, it would be useful to have some clarity as to how the obligations in respect of ESG preferences for financial instruments are taken into consideration.

### **Additional comment**

Even though we have focused our response on MiFID II and suitability requirements, it is important to make a final comment on the IDD draft delegated regulation to ensure consistency with our recommendations.

As mentioned above, the text of the MiFID II suitability requirements proposal wrongly uses the term 'most suitable products'. It appears that the text of the IDD draft delegated regulations uses the same language, 'most suitable products' – Recital 8 says: *“To enable insurance intermediaries and insurance undertakings to recommend the most suitable products to their customers or potential customers, those operators should introduce in the suitability assessment questions that help identify the customer’s ESG investment objectives.”*

Once again, we would like to reinforce the fact that the reference to 'the most suitable' is not correct and is not coherent with the text of MiFID II and IDD. Therefore we would recommend the Commission to modify this Recital to reflect the current obligations as 'suitable products or services'.

#### **Contact details**

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