Asset Management & Investment Funds Update

February 2022

ESMA Consults on Revised MiFID Suitability Guidelines

On 27 January 2022, ESMA published for consultation a revised set of guidelines for the MiFID suitability rules (the **Guidelines**) which rules require investment firms providing investment advice and portfolio management (including UCITS managers and AIFMs with MiFID top-up licences) to assess the suitability of a given investment or service before recommending it to clients. In addition to reflecting the sustainability preference rules, the revised Guidelines also include a new annex setting out good and bad practices identified during the ESMA 2020 common supervisory action.

The consultation on the revised Guidelines is open until 27 April 2022. ESMA expects to collate feedback from the consultation and issue final revised Guidelines in Q3 2022, for application two months after the publication of the translated versions on ESMA's website. The revised Guidelines, once applicable, will replace the existing 2018 Guidelines.

Reason for updating the 2018 Guidelines

The 2018 Guidelines are principally being revised to take account of the new MiFID sustainability preference rules which will amend the MiFID suitability rules once they come into effect on 2 August this year. Once effective, the sustainability preference rules require firms to assess, as a second step following the assessment of clients' knowledge, experience, financial situation and other objectives, clients' potential sustainability preferences using a self-assessment style model. Under the MiFID sustainability preference rules, a client's sustainability preferences are its choice between investing in:

1. products or instruments with a minimum proportion of sustainable investments as defined under the Sustainable Finance Disclosures Regulation (**Sustainable Investments**),
2. products or instruments with a minimum proportion of Sustainable Investments that comply/align with the Taxonomy Regulation (**Taxonomy-aligned Sustainable Investments**); and/or
3. products that consider the principal adverse sustainability impacts (**PAIs**) of investment decisions

(together the **Sustainability-Related Products**).

In acknowledgement of the likely limited availability of Sustainability-Related Products once the new rules come into effect next August and in a departure from the existing suitability assessment rules and guidelines, a firm may recommend products other than Sustainability-Related Products if it cannot meet a client's sustainability preferences. Such a recommendation is only permitted if the client, on being advised of the lack of available Sustainability-Related Products, elects to adapt its sustainability preferences. Only after a client has adapted their sustainability preferences, which adaptation is only applicable to the suitability assessment in question, can a firm recommend products other than Sustainability-Related Products.

Retail and professional investor services

While the Guidelines apply principally to retail client services, they should also be applied, where relevant, in respect of professional clients.

Wider impact of MiFID sustainability preference rules and the revised Guidelines

A key objective of the revised Guidelines is to avoid greenwashing in the distribution of sustainable investment products by specifying the features of those products suitable for recommendation to MiFID clients with sustainability preferences. However, those specified product features are more prescriptive than the features used to classify sustainable products under SFDR. Under SFDR there are two types of sustainable products, those in scope of Article 8 SFDR which promote environmental and/or social characteristics (so-called light green products) and those in scope of Article 9 SFDR with Sustainable Investment objectives (so-called dark green funds). In effect, the MiFID sustainable preference rules create a sub-set of sustainable products when compared to SFDR by excluding Article 8 SFDR products which promote environmental or social characteristics other than by investing in Sustainable Investments or integrating PAIs. Such Article 8 SFDR products are not suitable for MiFID clients with sustainability preferences unless there are no Sustainability-Related Products available and the client elects to adapt its initial sustainability preferences.

Revisions to the 2018 Guidelines

The proposed revisions to the Guidelines will, once finalised, require firms to review and adjust their suitability assessment processes and procedures and adopt 'robust and objective procedures, methodologies and tools' to assess the sustainability features of products recommended to clients.

One of the key difficulties in implementing the MiFID sustainability preference rules and once finalised, the Guidelines, is how to adequately, yet concisely and in a non-technical manner, explain the features of Sustainability-Related Products and obtain the necessary information from clients to make suitable recommendations. Industry initiatives, including the update of the FinDatEx European MiFID template, are underway to streamline firms' and distributors' requests for client sustainability preferences. Such initiatives have keenly anticipated the publication of the revised Guidelines and will be focussed on the following suggested step approach to collecting information as outlined in the revised Guidelines:

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STEP 1: qualitative assessment of sustainability preferences

Collect information on the degree of clients' sustainability expectations by reference to one or more Sustainability-Related Product features	For example, using yes/no questions, ask whether the clients would prefer one, more or all of these features included in its preferences

STEP 2: assess environmental, social or governance focus

Collect information on whether the client's sustainability preferences are focussed on environmental (E), social (S) or governance (G) criteria

STEP 3a: assess minimum sustinable investment preference

Collect information on the preferred minimum investment in Sustainable Investments and Taxonomy-aligned Sustainable Investments	For example, by requesting specific percentages or ranges presented in a neutral and sufficiently granular way

STEP 3b: assess PAI appetite

Collect qualitative and quantitative information on the client's appetite for PAI integration	For example, by asking as to any E, S or G focus and using categories of PAI indicators under SFDR rather than individual indicators	A qualitative evaluation could then be done of each preferred category based on products' PAI integration approach e.g. exclusionary screening, controversies or voting/engagment policies

Contingent step: no Sustainability-Related Product preference

Firms should establish a process for clients which have suitability preferences but do not indicate a preference for any Sustainability-Related Products	For example, firms could consider of any of the Sustainability-Related Products' features, a combination thereof and would not be subject to any minimum proportion of sustainability-related expection

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Next steps and compliance challenges

While industry continues to lobby for a delay, the effective date of the MiFID sustainability preference rules is currently fixed for 2 August 2022. Based on ESMA's indicative timeline for final Guidelines, firms are unlikely to have the benefit of Level 3 guidance when preparing for compliance with the sustainability preference rules. There is also the data issue arising from the delayed finalisation and application of the SFDR Level 2 measures until 1 January 2023. Article 8 and 9 product disclosures required under SFDR Level 2 will provide investment firms with the minimum Sustainable Investment and PAI integration data necessary to allow for the assessment of products suitable for recommendation to clients with sustainability preferences. Without this data firms are very likely to struggle to identify available Sustainability-Related Products for recommendation. This is an issue which may, in the short term, result in a not insignificant number of firms relying on clients' adaption of initial sustainability preferences to allow firms recommend products other than Sustainability-Related Products.

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