Response to ESMA's call for evidence on the integration of sustainability preferences in the suitability assessment and product governance arrangements

EXECUTIVE SUMMARY

Retail investors are increasingly concerned about the impact of their investment decisions on society and the environment. In recent years, European Union (EU) institutions have amended the legislation regarding the distribution of retail investment products by investment firms–the Markets in Financial Instruments Directive (MiFID II)–and related delegated legislation and guidelines to define how investment firms are to collect their (prospective) client's preferences regarding the sustainability.

Following the entry into application of the amendments on 2 August 2022, the European Securities and Markets Authority (ESMA) launched a Call for Evidence (CfE) to gather information about the ways in which investment firms have implemented the new requirements. These new requirements in particular imply additional questions asked to clients seeking advice on financial products, and additional information to be provided by financial advisors.

BETTER FINANCE, as the representative body of European retail investors, has been actively involved with EU policy-makers to ensure that the rules governing preferences collection and advice provisions protect the interests of retail investors, notably ensuring that they receive clear and comparable information.

BETTER FINANCE chose to submit a target response to ESMA's Call for Evidence. Indeed, as ESMA's goal with the CfE is to "gain a better understanding of how the MiFID II requirements are being implemented and applied by firms",[1] most of the questions require data and insights available only to investment firms distributing investment firms to retail clients. Furthermore, the changes that ESMA requests consumers' views on are still too recent for BETTER FINANCE and its members to have had the time to collect meaningful evidence from retail investors on their "experiences and reactions to the incorporating of

[1] European Securities and Market Authority (ESMA). 2023. 'Call for Evidence on MiFID II Suitability and Sustainability'. ESMA35-43-3599. Paris. https://www.esma.europa.eu/sites/default/files/2023-06/ESMA35-43-3599_Call_for_evidence_on_MiFID_II_suitability_and_sustainability.pdf. p.6.

sustainability factors within the services of investment firms".[2] BETTER FINANCE's responses to these selected questions can be found in the next section.

RESPONSES TO SELECTED QUESTIONS

Sustainable finance and financial education

Q2. Are there specific aspects of sustainable finance that retail investors struggle to understand? For example:

a) ***Understanding of general aspects such as why it is important to consider sustainability risks and factors when investing?***
b) ***Understanding differences between sustainable products and products without sustainability features?***
c) ***Understanding that sustainability characteristics and (expected) returns are two separate issues?***
d) ***Understanding the new legal definition of "sustainability preferences" and its components (e.g., categories a), b) and c), minimum proportion, principal adverse impact (PAIs), etc.?***

Retail investors are increasingly aware of the relation between investment decisions–including their own–and many of the environmental and social challenges that we collectively face. Numerous campaigns led, *inter alia* by civil society organisations and consumer organisations, have served to highlight this relation and lead savers to consider sustainability aspects in their choice of investment products.

That being said, understanding how sustainable finance *works* remains a challenge: Many EU citizens still lack sufficient financial literacy to understand the functioning of *traditional* packaged retail investment products (e.g., the impact of costs and charges or inflation on long-term returns), let alone *sustainable* ones, which require additional knowledge, or at least awareness, of non-financial performance factors.

Although we do not have precise data on this point, feedback from BETTER FINANCE members indicate that retail investors do have difficulties understanding the legal definition of "sustainability preferences" arising from EU law. It is clear that guidance on these issues is necessary to provide retail investors with the necessary background information to (a) formulate preferences regarding sustainability, (b) understand how the products recommended to them meet these preferences, and (c) compare products on offer with different investment firms.

It is therefore crucial that retail investors have access to high-quality, bias-free financial advice. Retail investors, who lack the necessary knowledge and time to conduct thorough research and comparisons of available investment products, must be able to rely on their financial advisors to carry out research and comparisons for them and recommend products that do meet their needs and objectives. Financial advisors should therefore be free from the influence of product manufacturers (i.e., not receive third-party payments), but that is a question beyond the scope of the present CfE.

Importantly, financial advisors should have sufficient knowledge and understanding of sustainable finance to properly assess investment products for their sustainability characteristics and explain in clear and

[2] Ibid.

concise way to their retail investor clients said sustainability characteristics as well as financial performance factors. We regret to say that this knowledge is currently lacking in many parts of the financial advisor profession.

Although not the object of the present CfE, we should note that reducing conflicts of interests and increasing the qualifications of financial advisors constitute two of the core objectives of the European Commission's Retail Investment Strategy proposals, which BETTER FINANCE strongly supports.

Q3. Are there specific financial education initiatives on sustainable finance developed by consumer associations, trade associations or other organisations and that are used by investment firms that you can bring to ESMA's attention? Please accompany your reply with any relevant background information on the initiative and/or with details on its effectiveness/usefulness.

Civil society organisations such as BETTER FINANCE have developed important tools to help (prospective) retail investors understanding sustainable finance. BETTER FINANCE's "Gateway to responsible investing" has been created and maintained with that objective in mind: the aim of the Gateway is to serve as a go-to point for anyone interested in conciliating financial returns and sustainability in their investment decisions, but lacking knowledge to understand sustainable finance.

The Gateway include various sets of resources, intended for users with different levels of knowledge and awareness. The home page sets the stage with the four main questions that an investor might ask themselves:

- What is sustainable investing?
- What are some of the examples of sustainable investing?
- How can you participate as a sustainable investor in the market?
- Why should you care about sustainable investing?

It then includes three main sections: "Responsible investing 101", "Knowledge hub" and "Investor education", as well as a "sustainability glossary" of terms related to sustainable.

- The **Responsible investing 101** section includes guidance to first-time sustainable investors:
  - What to ask for, what to check, what to bear in mind;
  - What tools are available (e.g., Key Information Documents, Benefits Statements) with links to ESMA and EIOPA Q&As on these documents;
  - Videos and other educational materials by BETTER FINANCE and its members offering explanations about various key notions related to investing
- The **knowledge hub** section gathers links to national, European and international-level initiatives related to sustainable finance and sustainability policy.
- The **investor education** section enables visitors to quickly find investor education initiatives throughout the EU and several neighbouring countries.

We do not have knowledge of investment firms referring (prospective) retail clients to initiatives such as BETTER FINANCE's Gateway, but we do think that this type of initiatives could be usefully referred to when a client mentions their interest in investing sustainably and asks for information. Information portals independent from investment firms themselves equip retail investors with the basic information that they need to enter into a discussion with their financial advisor and ask the right questions.

Q4: What is the main way firms currently provide information to retail clients about sustainable finance? For example:

- *Orally during the meetings with clients;*
- *Through educational brochures or other (paper) documents;*
- *Through dedicated websites and apps;*
- *A combination of the above;*
- *Other.*

In your opinion, are these approaches effective? Please provide details. Are retail clients satisfied with the quality of information provided?

However well-developed alternative information tools are, the main way in which retail investors receive information about (sustainable) investment products is orally at the point of sale, in meetings with their financial advisors.

Financial advisors play a key role is directing (prospective) clients towards the appropriate documents (KID, brochures, etc.) and online resources. Retail investor is not a full-time job: retail investors need the vast amounts of information about sustainable investment products to be curated for them, and they need to be able to rely on this curated information when taking investment decisions. That is why independent and well-trained financial advisors are crucial to increase retail investors' participation in capital markets generally, and particularly in markets for sustainable investment products, where the number of factors to take into account is much greater.

More and more retail investors–notably younger, first-time investors–use apps to manage their portfolios. In those cases, the app replaces the financial advisor as the primary provider of information on sustainable investment products. Well-designed app, that can provide the client with targeted, concise and reliable information are then paramount to ensure that (a) the right information is collected about clients' sustainability preferences and (b) the information that is delivered is sufficiently clear and comparable to serve as a basis for sound investment decisions.

Sustainability preferences

Q5: What are client's experiences/reactions to the new questionnaires including questions on "sustainability preferences"? (e.g. do they require guidance to be able to answer to the questions? Do they show interest in the topic?)

We do not have sufficient data to offer a reliable view of retail investors' experiences or reactions to the new questionnaires, although preliminary feedbacks from BETTER FINANCE members indicate that retail investors often *do* require guidance to understand the questions, in part due to the novelty of many notions related to sustainable finance.

Regarding interest, there is ample evidence available showing that a majority of (prospective) retail investors are indeed interested in the sustainability aspects of their investments (see, e.g., 2° Investing Initiative 2020). There are however indications that investment firms may have difficulties meeting these preferences with their existing portfolios of sustainable assets. In its latest report on robo-advisors, BETTER FINANCE (2023, 46–47) thus found that only a minority of robo-advisors in its sample allow for a comprehensive choice between a range of thematic options to be selected during the questionnaire. The majority of the robo-advisors we scrutinized propose sustainable investments to a very limited extent and often ask to change sustainability profile completely as no product is offered once a certain threshold of individual choices (regarding sustainability) are indicated in the questionnaires.

Q10. Are firms currently able to satisfy the sustainability preferences expressed by clients (in particular in relation to the three categories (Taxonomy, SFDR, PAI))? If so, for which categories and/or types of financial instruments do firms find it most difficult to satisfy clients' preferences?

We do not have sufficient data to draw conclusions about the difficulties investment firms in general may encounter to satisfy clients' preferences in relation to the thre categories.

However, the mystery shopping exercise that BETTER FINANCE conducted in the winter 2022/2023 for its research report on robo-advisors revealed that, even though an increasing number of the robo-advisors in our sample ask sustainability preferences to their clients following the publication of the new requirements, this progress remains extremely limited (see BETTER FINANCE 2023, 46–47). In many cases, the requirement to ask for sustainability preferences is unfortunately translated into a mere "tick the box" exercise; only two of the robo-advisors in our sample allow for a comprehensive choice between a range of thematic options to be selected as part of the questionnaire. Furthermore, none of the robo-advisors we investigated was able to issue a recommendation as soon as the client expressed preferences in relation to more than one of the three categories. Clients are then asked to take the questionnaire again. Even though our mystery shopping exercise only covered a limited sample of investment firms, we find that our results may be symptomatic of more widespread difficulties encountered by investment firms to satisfy clients' preferences in relation to sustainability.

One of our member organisations in Germany—the Deutsche Schutzvereinigung für Wertpapierbesitz e.V. (DSW)—conducted a survey of around 150 private retail investors regarding their experiences with sustainable investment advice following the entry into application of the new requirements. This survey carried out in September 2022 found that 64% of the participants did *not* follow the advisor's advice on sustainability and more than half of the sample stated that the advice did not meet their expectations (see DSW 2022).

Portfolio approach

Q18: Do you have any comments on the above practical examples?

The two proposed examples illustrate approaches which, while based on the same set of expressed preferences lead to widely different allocations of invested funds into sustainable vs. non-sustainable assets.

The coexistence of such different approaches is likely to lead to confusion for retail clients. Either each firm will need to explain in detail to each client how they go from a specific set of preferences to a particular recommendation– which will inevitably result in a cumbersome exercise for both the firm and the client–or any client who may compare recommendations made by two different firms on the basis of the same set of preferences will wonder why recommendations differ so widely.

Assessment of client preferences when the client expresses preferences for multiple categories

Q24: Does this correspond to practices adopted by firms? If firms have implemented a different approach, please provide further details.

As ESMA notes "[i]n practice, by checking several boxes on a form reflecting the options set out in letters a), b) or c) or Article 2(7) of th MiFID II Delegated Regulation, a retail client may reasonably expect that all of them would be taken into account."[3]

For clients, it is in fact reasonable to assume that if they are given the possibility to express preferences in all three categories of products, all of these preferences will be taken into consideration. It should therefore be made clear from the outset–that is, in designing questionnaires–that these categories are alternative and not cumulative.

The notion that sustainable investments can be defined following three different approaches is inherently difficult to grasp for the average retail investor. We can understand the rationale of firms allowing clients to express preferences in more than one category and use these as alternative sets of preferences, as this may facilitate the formulation of recommendations. Nevertheless, the client must be provided with a concise and clear explanation of the difference between these categories and how the preferences they express in each of them will be treated.

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[3] ESMA, op. cit., p. 17