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The new MiFID2 suitability regime. A practical checklist in 10 questions.

On 23 September 2022, ESMA published its long awaited Final Report with Guidelines on certain aspects of the MiFID2 suitability requirements (2022 ESMA Suitability Guidelines).

Our ESG Advisory Team has prepared an analysis of this important document.

If you have any question, please feel free to contact

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1. When do the 2022 ESMA Suitability Guidelines enter into force?

It is important to know that 2 August 2022 was – and is – a real deadline for the date of application of the new MIFID2 requirements on suitability. When asked by market participants whether a delay could be granted, ESMA reaffirmed that investment firms are required to "fully comply" with the new legal requirements as from 2 August 2022.

That said, ESMA has decided to set the date of application of its 2022 ESMA Suitability Guidelines to six months after the publication of the translation of the guidelines (rather than two months as was originally set out in ESMA's Consultation Paper). As we understand this, investment firms are required to fully comply with the new MiFID2 requirements as from 2 August 2022 but have a 6 month period to ensure they comply with the additional technical details set forth by ESMA.

All this has the following practical effect. Since 2 August 2022, all clients must be able to update their profile immediately with respect to their sustainability preferences. The investment firm must ensure that, if its client expresses an intention to do so, the necessary tools are in place. For clients who do not take an initiative on their own, the investment firm should update the client profile at the latest during the 'next regular update' of client information. Amongst commentators there seems to be some doubt as to the exact meaning of 'next regular update'. We recommend taking a cautious and pro-active approach in this respect.

Important impact

But perhaps even more importantly, it is key to note that, when a client has not requested the immediate update of its profile, during the period until the 'next regular update' has taken place, an investment firm is required to consider a client as 'sustainability-neutral'. This means that the client could be recommended products both with and without sustainability-related features. In our view this means that, in practice, since 2 August 2022, almost all clients fall by default within this category (see also **Question 7** about the relation of this default option with the 'duty of care').

2. Is compliance with the 2022 ESMA Suitability Guidelines a best effort obligation?

No. During the consultation period, the Securities and Markets Stakeholder Group (**SMSG**) noted that "it will be almost impossible for financial institutions to go beyond a 'best effort' compliance". As long as the Corporate Sustainability Reporting Directive (**CSRD**) has not entered into force, the lack of data on investee companies, or the fact that existing data are unreliable or even inconsistent, makes a mismatch between the proposed financial products and client expectations possible, and even probable.

On 10 November 2022, the European Parliament adopted the final CSRD text. The Council of the European Union is expected to adopt the proposal on Monday, 28 November, after which it will be signed and published in the EU Official Journal. The new reporting rules are expected to gradually enter into force between 2024 and 2028. This means that data quality remains a concern for the years to come.

Important impact

It is worthwhile to note that this may trigger potential liability: clients may end up under an impression of having been mis-sold products or having received inaccurate or even misleading information, whilst investment firms have relied on data that proved to be inaccurate or inconsistent. Whilst the SMSG comments make complete sense, unfortunately ESMA does not seem to have accepted a 'best effort' principle with respect to compliance.

There is no real solution to this problem. One way of dealing with this potential liability – in our advisory practice – is an open and transparent communication to clients. Investment firms could actively inform their clients of regulatory change, including the challenges resulting from the ESG rules. Such open communication would not amount to a traditional 'best effort', but would rather be a 'partnering up' with the client in a good faith attempt to make the regulations work. We will further elaborate on this in our upcoming client memo on greenwashing.

3. What is the 'sequential' approach to information collection?

The 2022 ESMA Suitability Guidelines confirm ESMA's approach to sequentially address sustainability preferences. In fact, a clear distinction must be made between the 'classic' MiFID2 test (on investment objectives, financial situation, ability to bear loss, and knowledge and experience) and the 'new' sustainability preferences test. Whilst ESMA expressly clarified that investment firms may use one questionnaire combining both tests, the information collection should be clearly separated: (1) the sustainability preferences should only be addressed after the 'classic' MiFID2 test and (2) the sustainability preferences test may not take precedence over the outcome of the 'classic' MiFID2 test.

In our view, if an investment firm decides to use one unique questionnaire, we recommend inserting specific 'flanking' wording to ensure that clients understand how the information collection process works. Again, this wording would not attempt to be a disclaimer, but instead be a good faith attempt to educate clients why the sustainability test matters, how it differs from the 'classic' test, and what the relation is between both tests. We also advise clients to be open and transparent about the fact that, by default, clients will be considered 'sustainability-neutral', and the important consequences this may have on the investment services being rendered by the investment firm (see **Questions 1 and 7**).

Important impact

4. How does the 'classic' MiFID2 test differ from the 'new' sustainability preferences test?

The two tests have a completely different nature – and it is important for investment firms to fully understand the consequences of this. Even though ESMA did not specifically point to the differences between both tests, we believe that investment firms should understand that the nature of the sustainability preferences test is substantially different from the 'classic' MiFID2 test. Even more so, the 2022 ESMA Suitability Guidelines have completely turned some well-established MiFID2 features upside down.

We give 2 examples. First, whereas in the context of the 'classic' MiFID2 test, educating clients to increase their knowledge was generally not allowed when conducting the test, there are no such limitations when educating these clients on ESG. To the contrary: advisors are expected to actively educate their clients on the ESG legal framework and explain key terms like Taxonomy, the PAI statement, etc. (see also Question 10). Second, whereas in the 'classic' MiFID2 suitability test, a client cannot decide to change the outcome of the test, (multiple) adaptations of the sustainability preferences test are expressly authorized – even in a suitability context. In our view, it will be essential to properly document this and, if one unique questionnaire is used, to add specific wording, clear communications and good faith transparency.

Important impact

5. Can a distinction be made between retail clients and professional clients?

Yes. ESMA confirmed that the 2022 ESMA Suitability Guidelines "principally address situations where services are provided to retail clients" and that they apply to professionals only "to the extent they are relevant". ESMA did not provide for more details but specific Q&As may be published at a later stage.

In our view, an example of distinguishing retail and professional clients could be that professional investors will not typically require concepts (such as ESG or Taxonomy) to be explained to them.

Medium impact

6. What if a client is not clear about its preferences?

Medium impact

Clients are expected to provide a prioritization in case of simultaneous sustainability preferences. However, if the client expresses multiple options but fails to mention a clear preference, the investment firm can interpret these options as alternative. The investment firm should make such an assessment in the client's best interest.

7. Can an investment firm recommend a product that does not match the client's sustainability preferences?

Important impact

The basic answer is: No. In the ESMA 2022 Suitability Guidelines, ESMA expressly confirmed that a firm cannot recommend a product that does not match the client's sustainability preferences. The only way for doing so, is to adapt, together with the client, the client's sustainability preferences. There is however one important exception: in case a client does not answer the question whether it has sustainability preferences or even if that client answers "no", the investment firm may consider this client as 'sustainability-neutral' and recommend products both with and without sustainability-related features.

In our view this exception may potentially conflict with the general duty of care as enshrined in MiFID2, or otherwise potentially result in a misunderstanding by the client. This becomes more clear if a more extreme example is considered: even if a client expressly demands the investment firm to invest in non-sustainable investments, according to ESMA, such a client is still to be considered 'sustainability-neutral' and therefore it is possible to invest in products with sustainability-related features. In order to avoid any risks in this regard, we recommend adding specific wording about this potential conflict in the questionnaire.

8. Is it possible for the client to change his/her sustainability to access a specific product offering?

Important impact

Yes. A client may at any time change its sustainability preferences. As stated above (Question 4), it is important to understand that the expressed sustainability preferences are of an entirely different nature that the other elements in the suitability process, such as knowledge and experience, which typically are static and cannot be changed that easily.

We believe that the internal procedures of the investment firm should correctly reflect the different nature of both levels of the suitability test. Internal procedures should make sure that it is not allowed to induce a client to change its sustainability preferences. There is also a clear link with product marketing. For instance, according to ESMA, a presentation by the investment firm of its product offering prior to the adaptation of the sustainability preferences is not allowed as it could highly influence the clients' answers.

9. What if the investment firm applies a portfolio approach to suitability?

In contrast with its earlier Consultation Paper, ESMA introduced more flexibility in this regard: it will be sufficient to obtain a quantitative indication of the client's sustainability preferences by gathering information on the 'minimum proportion' to be invested in sustainable instruments and when collecting information on which PAI should be considered. Unlike in the earlier proposals, it is not necessary for the investment firm to also collect information on the extent to which the client has sustainability preferences. The quantitative indication of the client's preferences in terms of a minimum proportion of investments with sustainability features in its portfolio can in turn be used when the investment firm applies a portfolio approach to suitability. When adopting a portfolio approach, the investment firm should also ask which part of the portfolio (if any) the client wants to invest in products meeting the client's sustainability preferences.

Finally, ESMA clarified that in a portfolio approach, an investment firm can, for example, apply the sustainability preferences (including the quantitative indication) (1) on average at the level of the portfolio as a whole or (2) at the level of the part/percentage of the portfolio the client wants to be invested in products with sustainability features.

Important impact

10. What is the impact on training programs?

The deadline of 2 August 2022 also applies to the training of staff: whilst it was acknowledged that trainings require time and effort, ESMA affirmed that it is key that staff possess the necessary knowledge and competence.

If not yet done so, we recommend to organize training programs to ensure that all employees facing clients know the key features of the ESG legal framework and know how to explain in a clear and comprehensible way, complex concepts like "Article 6, 8 and 9 SFDR", "Taxonomy", or "PAI statement".

Our ESG Advisory Team has prepared several training modules, with very concrete examples, and Q&A's. Please feel free to let us know should you wish to receive more information in this regard.

Important impact

ESG Advisory Team – We understand the pace at which dynamics are changing. We have set up an ESG Advisory Team putting together experts in banking, financial regulation, energy, corporate, capital markets, administrative law, data treatment, employment – all this to offer one advisory platform supporting our clients in responding to change, delivering on ESG, and converting challenges into opportunities.