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Public Response to ESMA35-43-2998: Guidelines on MiFID II Suitability Requirements

From Morningstar, Inc.

Submitted on 27th April 2022 **online** at www.esma.europa.eu 'Your input - Consultations'

To Whom it May Concern,

Morningstar appreciates the opportunity to comment on the proposed revisions to the Guidelines on Certain Aspects of the MiFID II Suitability Requirements. As a leading global provider of ESG ratings, research and data, with a mission to empower investors, we offer a variety of services to wealth managers, portfolio managers and financial advisers.

This experience informs our perspective on the impact of the proposed guidelines and their possible effect on the advice that investors receive, and overall, we believe the amendments will help firms and investors to practically incorporate consideration of sustainability preferences into suitability assessments.

The guidelines could be further enhanced by enhancing the standardisation of how sustainability preferences are explained to clients, in terms of what they constitute and how and why they are becoming a part of the assessment. ESG investing continues to evolve, as does the regulatory framework within which it operates and its breadth, coupled with the lack of consistent terminology, makes for conflicting views amongst industry professionals which we think could lead to very different explanations to clients from one firm to another.

Also, as we highlight in our response, there is both a wide range of ESG products, even amongst those identifying as SFDR Article 8 and a data gap that will persist and only gradually reduce over the first years of operation of the MiFID amendments. This data gap will complicate firms matching of products to preferences and the guidelines could assist firms by elaborating on good practices around the use of complementary questions and data to support their client conversations, as well as how they conduct the process iteratively, for example, by starting at a high level and progressively working toward the detailed preferences definitions.

On behalf of Morningstar, we again thank you for the opportunity to contribute and will be happy to engage further, answer other questions or provide additional information that may be helpful.

Yours faithfully,

Andy Pettit
Director, Policy Research (EMEA)
Morningstar

Responses to Specific Questions

Q1. Do you agree with the suggested approach on the information to clients about the purpose of the suitability assessment and its scope? Please also state the reasons for your answer.

The suggested approach is sensibly incremental to the established processes around the traditional elements of a suitability assessment. The new supporting guidelines in respect of sustainability aspects could benefit from expansion to provide more standardised explanation to clients about why sustainability preferences are incorporated and how those aspects are a second stage to the existing components of a suitability assessment. An example would be to incorporate in the guideline's examples of the different elements of, and approaches to, ESG investing and how those factors may contribute to, or detract from returns in different circumstances.

Q2. Do you agree with the new supporting guideline in relation to the information to clients on the concept of sustainability preference or do you believe that the information requirement should be expanded further? Please also state the reasons for your answer.

As we explain in detail in other parts of our response, the wide range of elements that fall under the broad ESG heading, coupled with the granularity of sustainability preferences as defined in the MiFID delegated act, make consistent dialogue difficult even amongst industry professionals.

While the traditional elements of suitability assessments are well defined and relatively easy to explain, the lack of consistent terminology, and the evolving nature of sustainable investing, means there will be inconsistent approaches to gleaning sustainability preferences from retail investors.

The assumption that sustainable investing is a single unified investment approach has led to confusion and a mismatch between investor expectations and investment outcomes. It is more accurate to say that sustainable investing covers a range of approaches that are used to apply a sustainability lens to investments. For these reasons we recommend the new supporting guideline be expanded further to provide a more standardised basis for consistent communications to retail clients.

To provide a practical example, in Morningstar's own Sustainable Investing Framework[1], illustrated in Exhibit 1, we identify six distinct approaches and place them along a continuum ranging from those that lean more toward *avoiding negative* outcomes, be they investment or real-world outcomes, to those that lean more toward *advancing positive* outcomes.

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[1] Morningstar Sustainable Investing Framework White Paper

Exhibit 1

Framework MAP

Investors can address sustainability concerns by applying exclusions, limiting ESG risk, seeking ESG opportunities, practicing active ownership, targeting sustainability themes, or assessing impact. In any given portfolio, fund, or investment strategy, these six sustainable investment approaches may play no role, a supporting role, or a leading role. While the approaches play no role for many funds, they contribute in a supporting role to a growing number of funds, mainly by “limiting ESG risk” or “practicing active ownership.” Funds for which sustainability plays a leading role often combine several, or even all, of these approaches.

For investor portfolios that consist of multiple underlying investment strategies or funds, the framework can be used to target exposure to the approaches most preferred by the investor and can be used to evaluate how much exposure an investor has to each approach.

It is also a reality that there will be an elongated transition period during which (1) advisers and clients will gain more familiarity with the topic and available investments and (2) the present data gap (detailed further in our response to Q3) will gradually be filled as Taxonomy, SFDR and PAI data comes on stream.

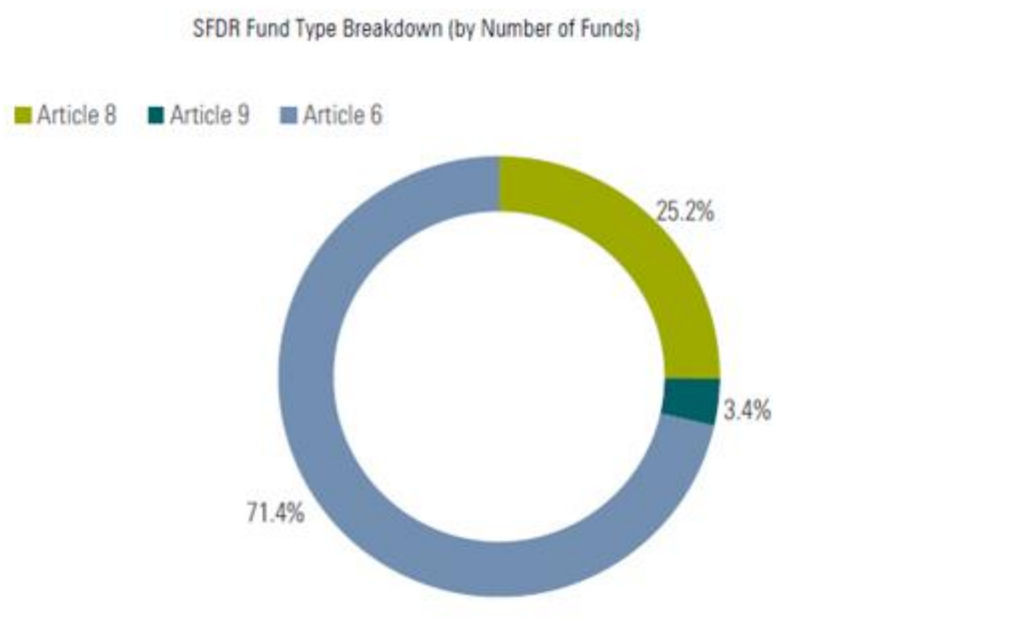
Including reference to this reality in the guidelines would help avoid circular conversations between advisers and their clients in the event that preferences are ascertained, but a lack of available products matching those preferences, leading the preferences to be revised and potentially reducing the clients’ confidence in, and value of the process.

Q3. Do you agree with the suggested approach on the arrangements necessary to understand clients and specifically with how the guideline has been updated to take into account of the clients' sustainability preferences? Please also state the reasons for your answer. Are there other alternative approaches, beyond the one suggested in guideline 2, that you consider compliant with the MiFID II requirements and that ESMA should consider? Please provide examples and details.

We caution that in the near-term there will be an inevitably data gap when advisers seek to match products with client preferences due to the different effective dates of the MiFID delegated act, Taxonomy reporting and SFDR disclosures. This data gap will only improve gradually.

Using data from Morningstar Direct, we show in Exhibit 2 that approximately a quarter of EU investment funds defined themselves as Article 8 products and a further 3.4% as Article 9.

Exhibit 2



Source: Morningstar Direct. Data as of 31 Dec 2021. Based on SFDR data collected from prospectuses on 91% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

These groupings include a disparate range of product types with varying degrees of, and approaches to, sustainability as illustrated in Exhibit 3.

Exhibit 3: Trends of SFDR classification of different strategies[2]

Article 8	Article 9
Exclusions Exclusions + ESG Integration Exclusions + ESG Integration + Engagement ESG Integration + Engagement Portfolio-Level ESG Score Security-Level ESG Score *Best-in-Class* *Thematic* *Impact*	*Best-in-Class* *Thematic* *Impact*

In the context of the MIFID guidelines, this means that the sustainable investment thresholds may mean very different things depending on the underlying investment strategies. Distributors will practically have to assess data beyond the preferences definitions relating to Taxonomy, SFDR environmental and social characteristics and PAIs to select potential investment solutions.

Further, research conducted by Sustainalytics[3], a Morningstar company, in March 2022, found that many product manufacturers are not yet committing to any level of Taxonomy alignment in respect of either Article 8 or Article 9 funds. While the subsequent ESA's guidance may alter this, we are aware of confusion and concern about the use of any 'equivalent' data ahead of actual Taxonomy data starting to be released by corporations in 2023.

With specific regard to data availability, as of 5th April 2022, Morningstar had received a 66% response rate to a survey of 68 asset managers across 15 countries. A little over half expect to be producing the FinDatEx industry European ESG Template, or EET, by June, while over 30% are yet to determine if or when they will do so and with what frequency of update.

Considering all these factors, there is a real likelihood that very detailed client conversations in the early stages may be moot either because the client deems the topic too complex, or because no products match the resultant preferences, subsequently requiring them to revise their preferences.

These issues could be tempered by making it clear in the guidelines that advisers not be constrained to the three defined elements of sustainability preferences and utilize complementary questions and data to support their client conversations, as, for example, outlined in the third of the good practice's presented in Annex IV of the consultation paper. Further, distributors should be encouraged to warn clients on the current state of Taxonomy

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[2] *SFDR: Four Months After Its Introduction Article 8 and 9 Funds in Review* (Morningstar, 27 July 2021)
[3] https://www.sustainalytics.com/esg-research/resource/investors-esg-blog/eu-Taxonomy-alignment-of-article-8-and-9-funds-reporting

data (at least until 2024) as well as highlighting that its' scope will be expanding from its initial climate focus.

While only indirectly related to MiFID 2 and to the guidelines, we do believe that the data gap and consequent reduction in the number of products potentially meeting a client's environmental preferences could be alleviated by the use of estimates and proxies. Evaluating Taxonomy DNHS criteria and Taxonomy alignment will usually require a degree of estimation and judgement because of its' complexity and interpretable nature of some of the technical screening criteria and the unlikelihood of all necessary data being available in every circumstance, especially for activities outside the EU.

Q4. Do you believe that further guidance is needed to clarify how firms should assess clients' sustainability preferences?

For the reasons outlined in our response to Q3, we recommend that more standardized guidance is required, along the lines of the example provided in our response to Q2.

We welcome the ESMA's approach allowing reference to the main buckets of PAI, without having to dive deep into all individual KPIs defined under the annex of the SFDR delegated act. We would recommend one additional prior step for an explanation to be provided to clients about what the "consideration of PAI" means (as, for example in our sample table above). A third step may be for distributors to refer individual KPIs, which, subject to data availability, should ease comparability between these products.

Q5. Where clients have expressed preference for more than one of the three categories of products referred to in letters a), b) or c) of the definition of Article 2(7) of the MiFID II Delegated Regulation, do you think that the Guidelines should provide additional guidance about what is precisely expected from advisors when investigating and prioritizing these simultaneous / overlapping preferences?

We illustrate in Exhibit 4 how significantly different two Article 8 funds in the same category can be and provide an indication of different data fields that can assist with product screening.

Exhibit 4: Examples of Different Types of SFDR Article 8 Products

Examples of Article 8 Funds

"Promotes environmental and social characteristics when selecting the companies in whose shares and equity ……..considers ESG ratings from industry-leading data providers ………with a view to investing in companies that have better social or environmental practices than their industry peers ……………………..the Investment Manager works with additional exclusionary criteria……"

Global Category	Europe Equity Large Cap
EU SFDR Fund type (Article 8 or Article 9)	Article 8
Sustainable Investment- Environmental Sector Overall	No
Sustainable Investment- Impact Fund Overall	No
Morningstar Rating Overall	3
Morningstar Sustainability Rating™	Low
Carbon Risk Score	15.56
Employs Exclusions- Alcohol	No
Employs Exclusions- Tobacco	No
Employs Exclusions- Small Arms	No
Employs Exclusions- Gambling	No
Employs Exclusions- Controversial Weapons	Yes
Employs Exclusions- Adult Entertainment	No

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Example of Article 8 Funds

"..sustainability is significantly integrated into the … stock research… will assess equities using a norms-based evaluation … based on …United Nations Global Compact Principles for Business which cover… human rights, labour rights, environmental safeguards and combating bribery and corruption. .. will not invest in equities which …..derive more than 10 per cent. of their annual revenues from (a) the production or sale of alcohol, weapons and armaments or adult entertainment; (b) fossil fuel extraction and production; (c) the provision of gambling services; and (d) the sale of tobacco will be excluded….."

EU SFDR Fund type (Article 8 or Article 9)	Article 8
Sustainable Investment- Impact Fund Overall	Yes
Global Category	Europe Equity Large Cap
Index Fund	No
Morningstar Rating Overall	3
Morningstar Analyst Rating	
Morningstar Sustainability Rating™	High
Carbon Risk Score	4.42
Employs Exclusions- Alcohol	Yes
Employs Exclusions- Tobacco	Yes
Employs Exclusions- Small Arms	Yes
Employs Exclusions- Gambling	Yes
Employs Exclusions- Controversial Weapons	Yes
Employs Exclusions- Adult Entertainment	Yes

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When a preference for more than one of the three categories is expressed, the process of identifying and applying sustainability preferences can get quite detailed quite quickly. We provide a simplistic example in Exhibit 5 and further guidance would undoubtedly benefit firms in this regard.

Exhibit 5: Matching Preferences to Products

Practical Example of Finding an Appropriate Product

EU Taxonomy Alignment	Yes
If Yes - what minimum portion	15%
SFDR Classification	Article 9
If Yes – what minimum portion	30%
Principle Adverse Impacts	
If Yes - Select indicators.	Green House Gas Emission

Finding a Solution in August 2022

Based on current data gap, the options would be:

- Screen on Article 9 funds

In absence of sufficient data for EU Taxonomy or Principle Adverse Impact data:

- Use Morningstar Calculated PAIs on Green House Gas Emissions
- & Carbon Intensity & Carbon Risk Scores (supplementary data not regulatory)

Finding a Solution in August 2023

Screen for:

- Screen on Article 9 funds
- With 15% Taxonomy Alignment
- Using Green House Gas Emissions Indicators

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For the purposes of consistency, additional clarity about (1) the data against which preferences are matched would be helpful, specifically the priority that firms should give to preliminary ex-ante data and the stated objectives of a financial product, versus actual ex-post data at the end of accounting periods and (2) if and how individual stocks within a client portfolio should be assessed against preferences would also be welcome by a number of adviser clients with whom we have spoken.

Q6. Do you agree with the proposed approach with regard to the assessment of ESG preferences in the case of portfolio approach? Are there alternative approaches that ESMA should consider? Please provide possible examples.

It should be acknowledged that the approach will be subject to the data challenges referenced in our response to Q2 and Q3 and which will likely contribute to a continual and significant expansion of potential products each time a firm conducts a client review.

As well as new products, we would highlight that asset managers are increasingly repurposing existing funds as sustainable. In 2021, Morningstar identified[4] 536 funds across Europe were repurposed as sustainable, double the number re-labelled the previous year. The guidelines might benefit from a specific reference to monitoring that clients existing holdings continue to conform with their sustainability preferences.

Q7. Do you agree with the suggested approach on the topic of 'updating client information'? Please also state the reasons for your answer.

[4] https://www.morningstar.com/lp/global-esg-flows

Yes, as in principle the updating of client information in respect of sustainability preferences should be the same as for other suitability related information and commence as proposed after the entry into force of Commission Delegated Regulation 2021/1253.

Q8. Do you agree with the suggested approach with regards to the arrangements necessary to understand investment products? Please also state the reasons for your answer.

Ultimately the guidelines should be expanded to help distributors and clients navigate through the different product types and concepts introduced by SFDR and the Taxonomy by using plain language. The guidelines can also be the opportunity to match the regulatory definitions with market practices, in an illustrative, non-mandatory way. The table in Exhibit 6 encompasses all our recommendations mentioned above and allows to visualise how they could help distributors and clients identify sustainability preferences.

Exhibit 6: An Example Approach to Simplifying the Explanation of Sustainable Preferences

<table>
<tr><th>Sustainable Preferences</th><th>Potential Guidelines Clarification</th><th>Corresponding Classification (Morningstar example)</th><th>SFDR Classification Trends of Different Strategies</th></tr>
<tr><td>Taxonomy :
A financial instrument invested in environment ally sustainable investments</td><td>A product making investments <u>that contribute to climate change adaption and mitigation objectives</u> as defined under the EU Taxonomy. The EU Taxonomy, which is a classification system establishing a list of environmentally sustainable economic activities, is not yet operational for all environmental activities (i.e. biodiversity, circular economy, protection of water and marine resources, pollution prevention) and socially sustainable economic activities. The investment universe is narrower than in the previous case mentioned above (see SFDR SI). Data on Taxonomy alignment will be incomplete at least until 2024.</td><td rowspan="2">Improve the world by:
• doing no harm (avoiding negative impact)
• seeking a positive impact (practice active ownership or target sustainability themes)
Leading role: sustainable investment approaches central to investment process</td><td>-Taxonomy</td></tr>
<tr><td>SFDR:
A financial instrument invested in sustainable investments</td><td>A product making investments that <u>contribute positively to an environmental or a social objective</u>, provided that the investments do not significantly harm any environmental or social objective and that the investee companies follow good governance practices. Sustainable investments with an environmental objective might be aligned with the Taxonomy or not.</td><td>-Portfolio/security-Level ESG Score
-Best-in-Class
-Thematic
-Impact</td></tr>
</table>

A financial instrument that considers principal adverse impacts on sustainability factors	A product **minimizing ESG risks or impacts** A financial product that considers (i.e. avoid or minimise) principal adverse impact (e.g. avoid large Co2 emitters) to either minimize ESG risks or impacts of the portfolio. It does not necessarily make a sustainable investment. **Minimizing ESG impacts** means excluding or limiting investment in companies, sectors or sovereigns deemed to generate the most significant negative impacts on environmental, social and governance aspects. **Minimizing ESG risks** means investing in selected companies, which are and intending to reduce and/or manage their most significant negative impacts on environmental, social and governance aspects.	**Improve investments/portfolio by:** • considering ESG risks • seeking ESG opportunities **Supporting role:** consider some ESG information as part of the investment process	- Norms-based exclusions - Sector/issuer-based exclusions -ESG Integration -Engagement -Portfolio/security-Level ESG Score -Best-in-Class -Thematic

Q9. Do you believe that further guidance is needed to clarify how firms should take into consideration the investment products' sustainability factors as part of their policies and procedures? Please also state the reason for your answer.

We believe further guidance and examples would be beneficial, for the reasons outlined in our response to Q5.

Q10. Do you agree with the additional guidance provided regarding the arrangements necessary to ensure the suitability of an investment concerning the client's sustainability preferences? Please also state the reasons for your answer.

We agree. The guidance allows for a broad set of products to first be identified as potentially meeting a clients' needs and objectives, regardless of their degree of sustainability. A subset can then be identified that do so, while also best matching the clients' sustainability preferences can be identified.

Q11. Do you agree with the approach outlined with regards to the situation where the firm can recommend a product that does not meet the client's preferences once the client has adapted such preferences? Do you believe that the guideline should be more detailed? Please also state the reasons for your answer.

We are concerned that this scenario could devalue the objective by generating circular discussions, with clients specifying preferences that can't be matched. Rather than then revising those preferences it would be preferable to retain them and have them re-tested against available products at subsequent reviews, with the client able to accept a firm's recommendation in the interim, subject to the firm documenting the client decision.

Q12. Do you agree with the approach outlined with regards to the situation where the client makes use of the possibility to adapt the sustainability preferences? Please also state the reasons for your answer.

We reiterate our suggestion in our response to Q11 and also suggest there be a limit on the number of times preferences can be amended without undertaking a further full sustainability assessment.

Q13. Could you share views on operational approaches a firm could use when it does not have any financial instruments included in its product range that would meet the client's sustainability preferences (i.e. for the adaptation of client's preferences with respect to the suitability assessment in question/to the particular transaction and to inform the client of such situation in the suitability report)?

Depending on what data an adviser can use to match the preferences, this will be a highly likely scenario in the early years. Informing the client whether the case arises because the firm does not offer such products, or, whether, to their knowledge, no such products exist in the market would facilitate the clients choice of how to proceed.

Q14. Do you agree with the proposed approach for firms to be adopted in the case where a client does not express sustainability preferences, or do you believe that the supporting guideline should be more prescriptive? Please also state the reasons for your answer.

We agree since the guideline effectively applies the existing whole-of-market approach and negates the sustainability overlay.

Q15. Do you agree with the proposed approach with regard to the possibility for clients to adapt their sustainability preferences in the case of portfolio approach? Do you envisage any other feasible alternative approaches? Please provide some possible examples.

We agree with a consistency of approach to sustainability preference adaptation and consequent re-balancing, subject to product availability and cost/ benefit justification.

Q16. What measures do you believe that firms should implement to monitor situations where there is a significant occurrence of clients adapting their sustainability preferences? What type of initiatives do you envisage could be undertaken to address any issues detected as a result of this monitoring activity?

No comment.

Q17. Do you agree with the proposed amendment to supporting guideline 10? Please also state the reasons for your answer.

We agree, because the amendment requires costs and benefits of the advice to be provided to the client.

Q18. Do you agree with the additional guidance regarding to the qualification of firms' staff or do you believe that further guidance on this aspect should be needed? Please also state the reasons for your answer.

No comment.

Q19. Do you agree on the guidance provided on record keeping? Please also state the reasons for your answer.

No comment.

Q20. Do you agree on the alignment of the two sets of guidelines (where common provisions exist for the assessment of suitability and appropriateness)? Please also state the reasons for your answer.

We support the alignment of the two sets of guidelines for the purposes of consistency and efficiency.

Q21. Do you have any further comment or input on the draft guidelines?

No comment.

Q22. Do you have any comment on the list of good and poor practices annexed to the guidelines?

No comment.

Q23. What level of resources (financial and other) would be required to implement and comply with the guidelines (organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

N/A