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Does MiFID II enable private investors to invest sustainably

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At a glance

- MiFID II is a comprehensive regulatory framework aimed at increasing transparency and oversight in the European financial markets, improving investor protection, and preventing market abuse.
- Amendments in 2021 to MiFID II[1] require investment advisors to query investors' sustainability preferences during investment consultations.
- A field study conducted by Cauthorn, Eckert, Kellers, Klein and Zwergel (2024) shows that investors are not recommended the types of sustainable products they want, and investment advisors frequently fail to query sustainability preferences.
- While the changes to MiFID II, which came into force in August 2022, were supposed to enhance financial market transparency and bolster private investors' access to sustainable products suited to their preferences, it seems the implementation of the regulation has not been as successful as hoped.
- The regulator should simplify the sustainability preference query and improve oversight to ensure that investment advisors better match their recommendations to their clients' preferences.

[1] Commission Delegated Regulation 2021/1253 of 21 April 2021 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, amending Delegated Regulation (EU) 2017/565

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Introduction

Private investors have been assigned a crucial role by the European Commission in financing the transition to a sustainable economy (European Commission, 2021). However, many private investors do not yet have the (sustainable) financial literacy necessary to invest their money sustainably (Gutsche and Zwergel, 2020; Filippini, Leippold and Wekhof, 2024). Furthermore, they frequently do not have access to the data required to invest sustainably. Therefore, investment advisors play a critical role in helping private investors find products that suit their preferences and ultimately contribute to the financing of the sustainability transition. This role is one of the reasons why the European Commission introduced changes to MiFID II, requiring investment advisors to query private investors' sustainability preferences. Changes to MiFID II are, i.a., supposed to ensure better protection of private investors while requiring investment advisors to account for private investors' specific sustainability preferences. This policy brief summarizes the extent to which investment advisors consider private investors' preferences, particularly sustainability preferences, when recommending investment products based on findings from Cauthorn, Eckert, Kellers, Klein, and Zwergel (2024). Understanding whether private investors are even able to access the products that match their preferences is vital in ensuring they are able to play their role in financing the transition to a sustainable economy.

Do investment advisors recommend suitable products to private investors? No, finds Mystery Shopping Field Study.

Research Approach

To investigate the alignment between private investors' preferences and investment advisors' recommendations, Cauthorn et al. (2024) conducted a comprehensive mystery shopping field study. Mystery shopping, in our setting, is a methodology that investigates how well certain criteria are met during real life investment consultations. Mystery shoppers are potential investors who assess pre-defined key parts of the investment consultation process. Investment advisors are not informed that the investment consultation is being evaluated to ensure normal behavior. Between March and August 2023, mystery shoppers collected data from 414 investment consultations, i.e. trained mystery shoppers attended investment consultations at retail banks throughout Germany to assess whether they could get the types of products they wanted. These mystery shoppers went through a multi-day training process where they learned about key EU regulations, e.g., MiFID II, SFDR and the Taxonomy; investment products; and the investment advisory process. These mystery shoppers were assigned one of three sustainable investor profiles: a) a preference for ESG-focused products, b) a preference for E-focused products, and c) a preference for products that limit negative firm externalities (Principle Adverse Impact products). This approach allowed the authors to assess whether the recommended products matched the investors' expressed preferences.

Research Results

The findings from Cauthorn et al. (2024) reveal a significant discrepancy between investors' preferences and investment advisors' recommendations.

- **Investment advisors do not cater to sustainability preferences**. Only 47% of the recommended products matched investors' desired sustainability preferences.
- **Investors' sustainability preferences are not correctly documented.** Investment advisors incorrectly document mystery shoppers' sustainability preferences and then recommend products suited to these incorrect preferences. This finding can partially explain the low level of correct preference consideration from the previous finding.
- **There are few suitable investment products recommended.** Investment advisors at banks that primarily recommended products from a single in-house asset manager recommend fewer suitable sustainable products to mystery shoppers.
- **Proactive intervention increases the likelihood of an incorrect documentation of sustainability preferences**. Mystery shoppers proactively voiced their preference to invest sustainably when investment advisors failed to query their preferences. These mystery shoppers see their sustainability preferences more often falsely documented than mystery shoppers that did not have to intervene because their preferences were queried.

- **An investment advisor's attitude towards sustainable investments matters**: Investment advisors who were perceived by mystery shoppers as having a positive attitude towards sustainable products recommended more suitable sustainable products.
- **Risk preferences are fairly well accounted for.** 87% of the products recommended by advisors matched investors' expressed risk preferences.

Interpretation of Results

The results underscore a critical need for regulatory reforms. Despite legally binding mandates, investment advisors frequently overlook, or even falsely document, sustainability preferences, leading to a mismatch between what investors want and what they are actually recommended during real investment consultations.

We recommend for EU regulators to take the following actions

- **Increase product diversification**. Require banks and financial institutions to offer a broader range of sustainable investment products from both external and in-house asset managers so investment advisors are better able to match products to investors' sustainability preferences.
- **Mandatory Sustainable Investment Certification**: Require investment advisors to hold a certificate demonstrating adequate knowledge about the importance of sustainability preferences, how to accurately elicit these preferences and document them, and about the differences between types of sustainable products.
- **The European Commission should modify the level two questions:** After investors voice a preference for sustainable products, they are asked to identify what type of preference they have. While the current level two questions might make sense from a regulatory perspective, they make little sense from an investor perspective. The product classification types are too vague for average private investors to understand and too complex for investment advisors to explain. Simplifying the questions could help ease the investment advisory process while bolstering access to suitable products. For

example, investors with sustainability preferences could simply be asked how sustainably (using the ESG scale[2]) they want to invest their money.

- **Strengthen Regulatory Oversight**: Enhance monitoring and enforcement of regulations requiring investment advisors to query and document sustainability preferences accurately.
- **Sustainable Finance Literacy**: Educate private investors about their right to have their (sustainability) preferences accurately matched to suitable (sustainable) products and how to determine whether product recommendations do match their preferences.

Implications and Future Steps

Implementing these recommendations should help ensure private investors receive investment advice that is aligned with their sustainability preferences. Enhanced regulatory oversight and increased product diversification should improve the quality of investment recommendations and bolster trust in the investment advisory process. Policymakers should prioritize these reforms to safeguard private investors' interests and ensure they are able to fulfil their key role in financing the transition to a sustainable economy.

It will now be important for ESMA and the European Commission to acknowledge these strong empirical findings and explore how investors' interests can be better protected in this specific regard. Apart from a (somewhat unrealistic) full review of the Directive, they should explore the other means at their disposal. Throughout 2024, ESMA, in close coordination with the European Commission, have looked into aspects of the MiFID II review that would merit additional guidance and clarity[3]. The European Commission has already tried to clarify some of the provisions of the MiFID II review and to provide guidance to financial market participants, through a communication and an interpretative notice. ESMA has organised public consultations in May and July of this year and plans two more for October 2024 and January 2025. Future consultations should include the key issues raised in this paper,

[2] https://sustainable-finance-beirat.de/wp-content/uploads/2024/02/PM_ESG-Skala_Abschlussbericht-1.pdf

[3] See: https://www.esma.europa.eu/trading/mifid-ii-and-mifir-review

and based on the consultation results, the issuance of further guidance should be considered.

Further research could investigate the potential benefits of replacing the second level sustainability questions during investment consultations with a question regarding the level of desired sustainability on a ESG scale. In conclusion, this policy brief highlights widespread issues in the query and documentation of sustainability preferences which in turn hinders private investors from getting the type of product they want. By addressing the identified issues, we can foster a more transparent, accountable, and investor-centric advisory process.

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About the project

The Sustainable Finance Research Platform is a joint project between five German research institutions conducting research on different aspects of Sustainable Finance, e.g. sustainable investments, sustainability risks and chances, and sustainability reporting. With their independent research, the project partners aim to support stakeholders in politics, the financial sector, and the real economy in understanding and shaping the central role of capital markets in achieving a net-zero economy. The researchers involved answer social, political, and business-related questions, provide established and new research findings, and participate in political and public debate. They also want to establish sustainable finance as a topic in the German research landscape and secure connections with international institutes and processes.

More information can be found on the project's website wpsf.de/en/.

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