ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

FINANCIAL MARKET PROFESSIONALS

AMAFI / 23-72
15 September 2023

INTEGRATION OF SUSTAINABILITY PREFERENCES IN THE SUITABILITY ASSESSMENT AND PRODUCT GOVERNANCE ARRANGEMENTS

ESMA's Call for Evidence

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AMAFI's answer

About AMAFI

AMAFI is the trade association representing financial markets' participants of the sell-side industry located in France. It has a wide and diverse membership of more than 170 global and local institutions notably investment firms, credit institutions, broker-dealers, exchanges and private banks. They operate in all market segments, such as equities, bonds and derivatives including commodities derivatives. AMAFI represents and supports its members at national, European and international levels, from the drafting of the legislation to its implementation. Through our work, we seek to promote a regulatory framework that enables the development of sound, efficient and competitive capital markets for the benefit of investors, businesses and the economy in general.

General comments

AMAFI views very favorably ESMA's initiative to tackle the implementation difficulties that investment firms face when applying the new ESG requirements of MiFID II.

Those difficulties are indeed numerous and serious enough to hamper the broad dissemination of ESG products to the public.

In that respect, it should be noted that the proportion of clients voicing any ESG preference when questioned is very low (20% only according to our members) and the percentage of clients voicing detailed ESG preferences is even lower (5% according to our members).

The reasons we see for this situation are:

- The granularity and complexity of the concepts used to ask clients about their ESG preferences, which are a hindrance both for clients to opt for such criteria and for advisors to encourage them to do so;
- The lack of definition of the key notion of "sustainable investment ", which by the way results in diverse approaches by investment firms (IFs), does not contribute to better understanding by clients;
- The lack of practical guidelines from advisors to clients on the state of the market, due to a rigid interpretation of the principle that IFs) shall not influence their clients;

- The misleading effect of this theoretical questioning on clients compared to the low level of market maturity;
- The complexity of the process based on an initial theoretical assessment of clients' ESG preferences, followed by many iterative changes;
- The lack of relevant data (e.g. CSRD is still not fully applicable), and for those that do exist, their lack of reliability;
- The lack of sufficient coordination between the different sets of rules (MiFID II, CSRD, SFDR), which complicates the use of data by IFs.

We therefore urge ESMA, within its remit, to consider how to resolve these difficulties.

Please note that AMAFI has not responded to questions for which it did not have sufficient or relevant information from its members.

I. SUSTAINABLE FINANCE AND FINANCIAL EDUCATION (§3.1)

Q1: What actions did firms implement within their organisation to take into account the new requirements related to sustainability preferences? Please elaborate especially on the following:

What proportion of firms' employees (differentiating between client facing staff and the other staff) have received training on sustainability topics? What did these trainings consisted of? Was any test or exam put in place?

In general, AMAFI members have implemented extensive ESG training programs for their client-facing staff. Those programs cover the following aspects: general information on sustainable finance and key concepts, information on MiFID II ESG requirements, information on ESG related internal processes and procedures. They are tailored to the category of staff targeted, being more detailed for staff involved in MiFID II processes. However, the general perception of the compliance departments overseeing this training is that, due to the complexity of the concepts and processes, investment firms' staff are still struggling to understand them properly. This could also be a barrier to the success of the new ESG processes.

Q2: Are there specific aspects of sustainable finance that retail investors struggle to understand? For example:
- Understanding of general aspects such as why it is important to consider sustainability risks and factors when investing?
- Understanding differences between sustainable products and products without sustainability features?
- Understanding that sustainability characteristics and (expected) return are two separate issues?
- Understanding the new legal definition of "sustainability preferences" and its components (e.g., categories a), b) and c), minimum proportion, principal adverse impact indicators (PAIs), etc)?

In general, our members feel that while general aspects related to sustainability are fairly well understood by clients, detailed ESG concepts, such as those used by the suitability regime, are quite difficult to understand.
One of the reasons is the absence of a definition for the crucial concept of sustainable investments, which by the way results in diverse approaches by investment firms (IFs), does not contribute to better understanding by clients.

In that respect, AMAFI suggests that ESMA bring some clarification of this central concept. We also suggest that ESMA work on some simple educational material that investment firms could use to educate their clients on ESG matters before asking them about their ESG preferences.

In a recent survey conducted by Opinion Way for the AMF, based on a representative sample of 2001 people aged 18 and over, more than 80% of respondents said they were satisfied or somewhat satisfied with the information provided by their bank or financial adviser on their environmental, social and governance (ESG) preferences[1]. However, the same survey also showed that clients still face many difficulties in understanding the concepts introduced under Article 2(7) of the MiFID II delegated regulation, such as "sustainable investment", "taxonomy" (and the difference between a and b products).
In the survey mentioned above, 74% of respondents admitted that they did not know what the Taxonomy was (76% for SFDR).

Q5: What are clients' 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?)

Overall clients appear to be very confused between the different concepts and more generally on ESG matters and often seek guidance from their advisor.

Many do not express an ESG preference: according to AMAFI members, a large majority of retail clients (about 80%), when asked about their ESG preferences, state that they have none, and only 5 % voiced detailed ESG preferences.

This is in line with a recent survey conducted by Allianz, which found that "*only 10% of the total sample considered ESG (environmental, social and governance) responsibility, although multiple answers were allowed*".

II. SUSTAINABILITY PREFERENCES (§3.2)

Firms questionnaires

Q8: How are firms collecting information from clients on their preferences concerning the minimum proportion? With regards to the use of standardised minimum proportions, which standardised minimum proportions are presented to clients?

AMAFI does not have statistics on IFs' practices regarding the collection of clients' ESG preferences. However, we have been working on the process of asking clients about their sustainability preferences and in particular the "*minimum proportions*" set out Article 2.7(a) and (b) of the MiFID II Delegated Regulation.

While ESMA's Guidelines on certain aspects of the MiFID II suitability requirements recognise the possibility for IFs to use standard minimum proportions[2] to collect their clients' preferences, they nevertheless impose that:

- These standard minimum percentages should be defined in a sufficiently granular way to allow the customer's sustainability preferences to be matched with the sustainability features of the financial instruments (*Guidance, §26 and 27*[3]*),*

[1] See page 69 of the survey : https://www.amf-france.org/sites/institutionnel/files/private/2023-07/OpinionWay%20pour%20AMF_%20Les%20Fran%C3%A7ais%20et%20les%20placements%20responsables_juillet%202023.pdf

[2] *"Where the client expresses preferences in terms of the "minimum proportion" as mentioned in points (a) and (b), firms could collect this information not in terms of an exact percentage but by minimum percentages. These percentages should be presented in a neutral way to the client and should be sufficiently granular. Firms could, for example, assist the customer to identify the minimum proportion by approximating the minimum proportion by standardised minimum proportions, such as "minimum 20%, minimum 25%, minimum 30%, etc "* (*Guidelines, §27, 3rd paragraph*).

[3] *"These percentages should be presented in a neutral way to the client and should be sufficiently granular. "*

- The IFs must gather the client's preferences without influencing its choice and must therefore adopt a neutral and unbiased approach (*Guidelines, § 26* [4] *and27* [5]).

With this in mind, AMAFI supports the position that client questioning should take the form of **minimum standard proportions in line with the range of sustainable products available on the market**[6]**,** which should be updated regularly as the market evolves.

AMAFI considers that questioning the entire theoretical range of possibilities would be misleading, contrary to the general principle according to which "*All information, including advertising, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading*" (*MiFID II , Art. 24.3*).

Basing the questioning on the entire theoretical range could lead clients to believe that the distributor can offer them products with very high sustainability percentages, which is not possible given the products currently available on the market[7]. This approach could therefore be considered misleading for clients. This was already pointed out in the SMSG's answer to ESMA's consultation on the revised suitability guidelines: "*The lack of data makes it difficult for distributors and manufacturers to have investment products on offer with elevated proportions of Taxonomy alignment or sustainable investments or which consider Principal Adverse Impacts by using quantitative indicators. Clients are not aware of these problems. Hence, a mismatch between expectations of clients and the availability of products is likely and must be taken into account.*"

Beyond the litigation risk the questioning on the entire theoretical range of possibilities would create for IFs, it would also expose them to reputation risk, with detrimental consequences for the level of trust with IFs and, more broadly, for clients' access to sustainable investments.

For example, the approach of collecting clients' preferences on a theoretical basis would lead to cumbersome and confusing processes for the client consisting of, in chronological order:

- information on the sustainability factors considered in the selection of financial instruments;
- questioning about ESG preferences;
- then repeated questioning with each new piece of advice to get the client to revise their ESG preferences, which are necessary for the provision of any advice.

The lack of client understanding that will inevitably result from this process is likely to create a form of annoyance or fatigue with sustainable finance. This could lead to a sense of green washing and deter customers from investing in sustainable finance[8], which is clearly not the desired outcome. This situation could even lead to a decline in the level of trust between investors and IFs, a trust that is essential to fostering investment in capital markets called for by the Commission.

AMAFI therefore supports the position that the questioning of clients should take the form of **standard minimum proportions in line with the range of sustainable products available in the market. Such minimum proportions would potentially be different for criteria a) and b), given the different levels of maturity on these 2 criteria**. They could be reassessed at a frequency to be determined based on changes in the offer available on the market.

[4] "*Throughout the process, firms should adopt a neutral and unbiased approach as to not influence clients' answers.*"
[5] "*These percentages should be presented in a neutral way to the client and should be sufficiently granular.*".
[6] And therefore necessarily different for criterion a) and criterion b) of Article 2.7. of the amended RD MIFII, given that the level of maturity of the market is different for alignment with the taxonomy and sustainable investments.
[7] See in particular: Travelling down the green brick road: a status quo assessment of the EU taxonomy (europa.eu)
[8] The adaptation procedure could discourage clients from expressing ESG preferences at the next review of their ESG profile.

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?

From a general perspective, and as previously stated in Q8, the level of maturity of the market is well below the expectations of clients, when expressed during the first step of the process (which again is quite rare – see answer to Q5).

Another difficulty lies in the lack of available data on the ESG characteristics of financial instruments[9] as well as in their reliability: data on Taxonomy alignment are often not available or if available, show very low Taxonomy alignment. The calculation methods used by different manufacturers for such alignment or for the percentage of sustainable investment appear to differ from one firm to the other.

AMAFI has also identified a difficulty in applying ESG suitability requirements to hedging transactions. This concerns derivatives such as FX or interest rate derivatives, which are used to cover a risk that is unrelated to any ESG consideration. Such derivatives are neutral from an ESG point of view as they are not linked to an economic activity and the concept of Taxonomy alignment is inapplicable to them (even though they may nevertheless be used as part of an ESG strategy). As the ESG contribution of these financial instruments cannot be assessed in accordance with the three conditions set by MiFID, their sale to clients with ESG preferences is prevented or at least made very complex[10].

Therefore, it should be clarified, e.g through a Q&A, that it is possible to sell such derivatives used for hedging purposes, whose ESG characteristics cannot be assessed according to MiFID to a client who has expressed ESG preferences. In due course, once a position has been elaborated on derivatives (see Q27 hereafter), MiFID will have to be amended to include the consideration of derivatives.

III. ASSESSMENT OF SUITABILITY (§3.3)

Portfolio approach

Q19: Have firms implemented an approach similar to the one described in examples 1 and 2? If yes, which of the two approaches have firms implemented? If firms have implemented a different approach, please provide further details.

There seems to be a variety of approaches (either as according to example 1 or according to example 2) amongst our members, also depending on the different business lines.

Consideration of Principal Adverse Impact (PAI) indicators

Q23: What are the issues that firms encountered in the consideration of PAIs from clients?

The concept of PAI is, among the 3 criteria used for the purpose of the assessment of clients 'ESG preferences, the most difficult to grasp.

This is because it is a negative concept. For example, it is not straightforward for a client to understand that when an IF takes into account the PAI on greenhouse gas emissions, the underlying investments should only not have a negative impact on such emissions (rather than having a positive one), and that all other PAIs may not be taken into consideration so that the same investment may negatively impact the other

[9] CSRD requirements are still not in force for all categories of issuers
[10] In that respect, it should be noted that the portfolio approach suggested in ESMA's suitability guidelines is not suited to wholesale markets, where the relationship is transaction based.

criteria. Conversely, it is not straightforward to understand that not taking PAIs into account does not necessarily harm sustainability.

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.

Yes, some of our members have adopted the alternative approach described under § 38 of ESMA's Call for evidence. Where this is the case, clients are provided with explanations on the approach, for example in the sustainability preferences questionnaire.

Understanding ESG products

Q26: What approach and criteria have firms adopted for the mapping of products' ESG features in view of their matching with clients' sustainability preferences?

AMAFI members use the Findatex EET templates, which provide very precise information on the ESG characteristics of the SFDR financial products in particular on their classification in categories a), b) or c) of Article 2(7) of the MIFID II delegated regulation.

Q27: How do firms apply sustainability-related concepts of Taxonomy Regulation and SFDR to MiFID II financial instruments that are outside the scope of SFDR (e.g., shares, bonds, certificates, etc.)? How do firms apply the "minimum proportion" concept to such instruments? In particular, how is the "minimum proportion" calculated?

The assessment of the sustainability dimension of financial instruments outside of SFDR for the purpose of applying MiFID II ESG preferences is specific to each type of instrument concerned. SFDR was designed with investment funds in mind, which means that its concepts are not always adapted to other financial instruments outside of its scope that warrant specific approaches.

The financial instruments outside the scope of SFDR for which AMAFI has carried out work on their potential contribution to ESG and, where possible, on possible methods to measure it, are derivatives, structured products in the form of EMTNs, plain vanilla bonds and shares.

- As regards derivatives:
  - AMAFI has been working for more than two years to substantiate the role that some types of derivatives can play in sustainable finance. We set up our working group at the time because the treatment of derivatives in the GAR appeared prejudicial (*see AMAFI / 21-47*).
    We have continued to discuss derivatives in the course of the various consultations that have touched on the issue (MiFID product governance guidelines – *AMAFI / 22-69*, fund names – *AMAFI / 22-13*, greenwashing – *AMAFI / 23-03*, SFDR RTS – *AMAFI / 23-54*). The industry is faced with the problem that the proposals on whether and how to account for derivatives differ depending on the topic under consideration, without consistency and sometimes with a prejudice against these products.
  - We emphasise that work needs to be done to agree on both the role of derivatives in sustainable finance and the calculation methods to account for them, irrespective of the various pieces of regulation involved. It is necessary to adopt a transversal approach to this issue and amend all relevant provisions in the different pieces of legislation in a consistent manner. In this respect the work currently being carried out by the EPSF on derivatives through its derivatives sub-group is of paramount importance in defining a harmonised approach.

- In our work, we have prioritised derivatives with shares and corporate bonds as underlyings because their Taxonomy alignment can be calculated. Other derivatives, such as interest rate or currency derivatives, also play a role in helping to finance sustainable activities or projects. However, this role cannot be quantitatively assessed in the same way as shares and corporate bonds derivatives because their underlyings are not linked to an economic activity (hence the concept of Taxonomy alignment is not applicable). The question of the assessment of commodity derivatives will also need to be tackled.

- Shares and corporate bonds derivatives can contribute to sustainability through the exposure they create/remove to the underlying asset. As with any secondary market instrument, their impact is not direct financing, but rather their effect on price formation and ultimately the cost of capital of the company concerned[11]. Derivatives through the negative or positive economic exposure they help investors to achieve, impact the demand for these shares/bonds in the secondary markets, contributing to their liquidity and price formation. Ultimately, exposure allows considering who bears the risk, as it may not be the person who has provided the cash who is bearing the risk. This is particularly relevant in the context of sustainability, where investors' appetite or lack of appetite for a company is likely to be gradually reflected in its valuation and cost of capital as the impacts of climate change increase.

- The sustainability impact of such derivatives should be calculated taking into account:
  - Long and short exposures: considering the net exposure is the only way to get a true picture of the exposure, whether negative or positive: as soon as the risk borne/offloaded by a market participant subject to disclosure is not zero, it should be considered.
  - The whole chain of market participants: This is necessary to get an accurate overall picture of the exposure to the asset (at the risk otherwise of "hiding" some exposure): after all, it is a zero-sum game, so each market participant's exposure needs to be taken into account (e.g. the counterparty's hedging is irrelevant to represent the investor's own exposure to the asset).
  - The delta method should be used to calculate exposures to the underlying shares or corporate bonds. The delta is the amount by which the value of the derivative increases or decreases for a given change in the price of the underlying. All financial institutions using derivatives compute the delta of their derivative positions on a daily basis for risk management purposes.
    This method is already used in EU legislation, albeit in different contexts, such as for the calculation of the net short position in shares in the Short Selling Regulation (*see in particular Annex II, Part I of the Commission Delegated Regulation (EU) No 918/2012*).

- As regards structured products:

  - The offer and distribution of structured products with ESG characteristics is developing without these products being explicitly regulated so far by the existing texts on sustainable finance, particularly as per SFDR.
  - However, it is possible to structure such products so that they satisfy clear and robust criteria to ensure a level of standard comparable to those established by existing regulations for other types of products.
  - The methodology used to measure the SFDR and Taxonomy alignment of these products is therefore a combination of the delta method used for derivatives and the consideration of the issuer's Taxonomy GAR.

[11] As referred to by the FCA in a consultation paper (FCA's consultation CP22/20, section 4.10, Box 3), there are three ways to influence corporate behavior for a positive outcome to sustainability: bringing new financing (e.g. loans and primary markets), exercising stewardship through voting & engaging, and influencing the cost of capital.

- Besides, AMAFI and AFPDB[12] have established a voluntary standard for ESG structured products packaged as EMTNs, which sets a number of ESG requirements for both to the underlying assets and the issuer, as these products combine the exposure provided by derivatives (see above) with an amount of financing for their issuer.

- As regards bonds and shares:

A bond or share's ESG characteristics are similar to those of their issuers[13]. Accordingly, the assessment of the ESG characteristics of such financial instrument should in theory result from the ESG reports such issuers are mandated to publish, either as per CSRD or the Taxonomy regulation.

However, the ESG data published are not required in a way that is directly useable for the purpose of MiFID II ESG provisions. Therefore, apart from large firms having developed specific expertise to analyse issuers' ESG reports, this could prove complex for many investment firms. This is all the more a matter of concern as these financial instruments are massively distributed under non advised services (see our answer to question 30). This creates another barrier to entry into the business of providing investment services, at the expense of the diversity of market participants.

IV. PRODUCT GOVERNANCE AND SUSTAINABILITY (§3.4)

Q30: How are firms, in their capacity as manufacturers and/or distributors, defining the target market for products with sustainability-related objectives, in terms of granularity? Please specify the elements that are defined for this purpose. Do firms adopt one single approach for all products, irrespective of whether they are in scope of SFDR? In case approaches differ, please explain why and how.

All IFs are required to determine a target market for the financial instruments they distribute, regardless of the investment service they use to distribute them, whether the distribution is active (e.g. through advertising or a recommendation, even a general recommendation) or passive (RTO or execution without prior recommendation).

However, prior to the entry into force of the amended guidelines on product governance investment firms could assess the target markets of shares and bonds using a standard approach[14] in accordance with the proportionality principle.

Such standard approach seems difficult to implement under current product governance requirements since an approach by product type does not make sense for the ESG criterion of the target market: it depends on the issuer, who is likely to have its own ESG characteristics.

However, the approach resulting from a literal reading of the guidelines according to which IFs providing pure intermediation services should determine the ESG target market for each of the products they

[12] Association française des produits de bourse
[13] Apart from specific cases like green bonds for which the use of proceeds is usually also taken into account for the assessment of sustainability.
[14] See in particular: "*Therefore, for more complicated products, such as structured products with complicated return profiles, the target market should be defined more precisely. For simpler and more common products, the definition of the target market may be less detailed:• For certain types of investment products, the producer may define the target market categories referred to in point 18 by adopting a common approach for financial instruments of a type with sufficiently comparable product characteristics (for example, because of an external benchmark or because they belong to a stock exchange segment with certain requirements). • Depending on the investment product, the description of one or more of the above categories may be more generic. The simpler the product, the less* precise *the category needs to be*" (*ESMA Guidance "on product governance requirements under MiFID II", §22*).

passively distribute, would raise important feasibility issues due to the large number of financial instruments concerned[15].

For this determination to be possible, only an 'industrial' process can be implemented given the number of financial instruments involved:

- For example, for IFs acting as distributors, this could mean either paying ESG ratings from ESG rating agencies or carrying out their own internal analyses (for example, using analyses from in-house centers of expertise, if any), for all ISIN codes distributed. Given the costs involved, this approach does not appear to be a viable solution for the vast majority of distributors and makes sense only for distributors who have chosen a commercial strategy based on ESG, otherwise resulting in a significant reduction in the range of financial instruments on offer. This would create another barrier to entry into the business of providing investment services, at the expense of the diversity of market participants.

- Another solution could be to assume by default that all the financial instruments distributed passively are "ESG indeterminate". This would not deprive clients of an essential protection since, under non advised services there is no matching of the target market at the time where the transaction is performed.

Therefore, we believe that IFs should always have the option by default to define the ESG target market of the financial instruments they distribute passively as 'indeterminate".

V. OTHER

Retail investors' demand of financial instruments with sustainability features and availability of products

Q36: Are firms facing specific issues related to data availability/data quality with respect to financial instruments with sustainability features? If yes, how are firms dealing with these issues?

Yes, as previously stated, IFs face a lack of available data on the ESG characteristics of financial instruments[16] as well as uncertainty on their reliability.

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[15] This is despite the fact that this information will not be used as part of the service they provide, and that MiFID II specifies that there is no negative target market based on the product's sustainability characteristics.
[16] CSRD requirements are still not in force for all categories of issuers.