ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

FINANCIAL MARKET PROFESSIONALS

AMAFI / 20-44
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FEEDBACKS TO EC
Sustainable Finance
–
MiFID II Delegated Regulation (organisational rules and suitability)
-
AMAFI's feedback

INTRODUCTION

About AMAFI. *Association Française des Marchés Financiers* (AMAFI) is the legal trade organisation representing financial market participants in France. AMAFI members are investment firms and credit institutions (French, European and global firms), operating in and/or from France (corporate and investment banks (CIBs), brokers-dealers, market infrastructures, exchanges and private banks). AMAFI has been extremely active on MiFID II issues. We are involved in all regulatory matters that concern commercialization of financial instruments. As far as financial products are concerned, we mostly represent all issuers/manufacturers of products (CIBs) but, through our private bank members, distributors as well. AMAFI has more than 150 members operating in equities and fixed-income and interest rate products, as well as commodities, derivatives and structured products for both professional and retail clients.

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AMAFI welcomes the opportunity to give feedbacks on European Commission proposed amendments to delegated acts under MiFID II[1] to include sustainability factors into the advice that investment firms offer to individual clients. Indeed, AMAFI pays particular attention to the development of ESG criteria in the financial markets and welcomes this objective to develop sustainable investments which are vital for our future.

In that context, AMAFI supports the proposal to require investment firms to take into account, when doing the suitability assessment as provided by MiFID II, the clients' sustainability preferences, in order to provide them with the most appropriate investment advice service.

This is why AMAFI read attentively the Commission new proposal of a draft Delegated Regulation amending Delegated Regulation (EU) 2017/565 (for the record, AMAFI took the opportunity to give feedbacks to the Commission first version of this draft Delegated Regulation[2] in June 2018 – see *AMAFI / 18-29* and to ESMA in February 2019 – see *AMAFI / 19-22*) and would very much like to outline the following general points before suggesting slight changes in the wording.

However, first of all, AMAFI wishes to insist on the flexibility and best effort logic needed for investment firms to take into account ESG considerations. Indeed, investment firms should have flexibility for determining ESG considerations of the client as well as for identifying ESG features of products.

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (link).
[2] See EC consultation's reference "Ref. Ares(2018)2681500 - 24/05/2018" (available through the following link, on the EC's website).

Furthermore, AMAFI notes that in order to define the concepts of sustainability preferences, sustainability factors and sustainability risks, the European Commission suggests referring to the Regulation (EU) 2019/2088 commonly referred to as the Disclosure regulation.

AMAFI notes that the Disclosure Regulation applies to a list of 'financial products' as defined in Article 2 (12) (a portfolio manager managed in accordance with point (6) of the 2019/2088 Article, an alternative investment fund (AIF) an IBIP, a pension product, a pension scheme, a UCITS or a PEPP) which are not considered as financial instruments under MiFID 2.

AMAFI is questioning the scope and consequences of this discrepancy: Are MiFID 2 products (equities, bonds, structured products, funds, derivatives, etc.) hence excluded from the scope of application and cannot qualify as ESG under MiFID 2's suitability and product governance regulation? That would be surprising and unforeseen if it is the case.
Conversely, assuming that MiFID 2 instruments are eligible for ESG criteria, on what basis/criteria will investment firms (under MiFID 2) assess the sustainability of their instruments?

In this sense, considering structured products for instance, AMAFI is currently working on developing a grid to categorize financial instruments according to ESG criteria. As such and as an example, a currently drafting decision tree diagram is presented in the annex of this document for this classification.

Given that no reference to the Disclosure Regulation appears in the ESMA consultation paper in 2018/2019, it raises serious questions that cannot be answered within a one-month period. It is therefore kindly suggested that the EU thoroughly considers these questions before publishing a final text.

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AMAFI COMMENTS

1. Implementation schedule. The implementation schedule of such new Delegated Regulation, notably the date of application, should be carefully considered. Indeed, as stated in 2018 and 2019 in its answers to the consultations of the Commission[3] and of ESMA[4], AMAFI considers that a cost-benefit analysis approach should be taken, between (1) the relative emergency of such measures to be enforced considering the forthcoming work on MiFID II refit and (2) costs for investment firms to implement successively 3 sets (*(i)* MiFID II as of 1rst January 2018, *(ii)* MiFID II as amended by MiFID Refit, and *(iii)* MiFID II as amended by the present Delegated Regulation) of changed requirements within 3 years.

(1) If developing sustainable finance is clearly an important and urgent issue, we would like to outline that MiFID II, through Product Governance requirements[5], already consider "*green*" and "*ethical*" investments as possible investment objectives to take into account into target market definition of financial instruments. These sustainability factors are therefore included in the new commercialization framework post MiFID II of financial instruments by both, manufacturer and distributors.

(2) Investment firms subject to MiFID II did a tremendous work in implementing the reform, including review all clients on boarding process in line with MiFID II requirements that apply since January 2018. With those amendments on ESG issues, firms would have to implement those changes within the next two years.

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[3] See *footnote n°2.* European Consultation, from 24 May 2018 to 21 June 2018 (link). See AMAFI's answer: *AMAFI / 18-29*.
[4] ESMA Consultation on Integrations sustainability risks and factors in MiFID II, from 19 December 2018 to 19 February 2019 (link) – Consultation Paper : ESMA35-43-1210. See AMAFI's answer: *AMAFI / 19-22*.
[5] « *The firm should specify the investment objectives and needs of target clients that a product is designed to meet* […]. *For example, a product may be designed to meet the needs of a specific age demographic, to achieve tax efficiency based on clients' country of tax residence, or be designed with special product features to achieve specific investment objectives such as "currency protection",* ***"green investment", "ethical investment",*** *etc., as relevant.* » (*ESMA Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA35-43-620*).

They potentially will have to change again once MiFID II/MiFIR Refit will entry into force. As a whole, it would result into 3 sets of the same requirements which might change twice in 3 years.

Would it not be sufficiently reasonable to ask the EU to re-evaluate the current legislative framework through amendments entering into force at the same time? All the more so as the changes incurred by the amendments contemplated will oblige to partially redesign procedures, internal process and IT systems developments, to question again clients to integrate their sustainability preferences (and redefine all onboarding questionnaires), redesign their product governance set up (including necessary exchanges between manufacturers and distributors) as well as training staff. Besides investment firms would need to take into account those changes in exchanges between manufacturers and distributors, notably to determine how a financial product could be considered as sustainable.

At last, AMAFI very much welcomes the Commission position to give competent authorities and investment firms a sufficient time to adapt to these new requirements as stated in recital (8) and article 2 of the new Commission Delegated Regulation proposal. However, AMAFI considers the proposed implementation period of 12 months is not sufficient. Indeed, according to AMAFI, an implementation period of 18 months is an absolute minimum. And, once again, all the proposed changes to the MiFID II delegated acts (for both ESG and Refit purposes) should enter into force at the same point in time.

2. Best effort logic for firms, especially for professional clients. Another important point in our view is that it seems absolutely essential to maintain for investors the possibility of *not* having sustainability objectives or considerations. It shall not be a requirement, for the client, to indicate sustainability preferences. Symmetrically, the investment firm should be in "best effort" logic for determining sustainability factors of the client.
In other words, investment firms should benefit from flexibility in determining and collecting ESG considerations of the client. It could be required from the firm to ask for information on that aspect but it should not be required to actually getting it. When a client does not have sustainability considerations or does not wish to disclose its preferences, this should not prevent the investment firm from providing him advisory or portfolio management services. Moreover, investment firms cannot be required to classify their investors into ESG categories.

This is particularly crucial where the client is a professional client. In accordance with article 54.3 of Regulation 2017/565, a firm is not required to assess, for a professional client, his level of experience and knowledge nor his financial situation. The firm, however, is required to assess his investment objectives to ensure that the service provided is suitable with those. Therefore, any requirement that concerns investment objectives may apply in relation with professional clients (provided that, of course, an investment advice is actually provided). Firms have generally more difficulty to collect "personal" information from professional clients and in some context; sustainability factors might not be relevant at all for those professional clients where acting on their own behalf.

That is why AMAFI wishes to suggest adding "*where relevant*" with "sustainability factors or preferences or risks" in all relevant articles of the draft Delegated Regulation. Indeed, according to AMAFI, the Commission's suggestion of wording "*any*" sustainability preferences/factors" does not exactly reflect the principle involving that clients do not have necessarily sustainability considerations; nor that such sustainability preferences/factors are necessarily relevant. Also, future guidance from ESMA on that particular point might be appreciated to reaffirm that expectations should lower in the context of the wholesale market.

Similarly, since it is essential to recognise the possibility that clients do not have sustainability considerations or preferences, AMAFI suggests to add in Article 33 "*if any*" after the addition of "including his or her sustainability preferences".

3. No relevance to develop sustainability considerations in organisational requirements. As stated in its answer (*AMAFI / 19-22*) to the public consultation of the ESMA on integrating sustainability risks factors in MiFID II (ESMA35-43-1210), AMAFI does not think it is relevant to develop sustainability considerations on the organisational requirements of MiFID II. AMAFI has doubts about considering that amending those requirements is the appropriate way to integrate sustainability risks in the "advisory process" of firms. We do believe that amendments in product Governance and Suitability requirements are relevant – and sufficient – to that objective.

AMAFI understands that through the reference to Article 2, point (22) of Regulation (EU) 2019/2088 of the European Parliament and of the Council ("Disclosure Regulation"), such ESG risks are defined as "*environmental, social or governance event*(s) *or condition*(s) *that, if it*(they) *occur*(s)*, could cause an actual or a potential material negative impact on the value of the investment*". Again, such definition demonstrates that ESG risks are risks that imply a loss in matter of investment. However, we do not understand the relationship between investments and organisational requirements. We believe that such link does not have its place here.

More practically, we find it unclear how the integration of sustainability into some of these general organisational requirements is intended to be carried out in practice. At the least, we would feel that further clarification through level 3 Guidelines that would include several specific examples of measures expected from investment firms on that matter, because there is a lot of topics within these organisational requirements within which it is not clear how to take into consideration sustainability risks. In our view, the objective is to take into account any sustainability preferences of clients but this should only impact commercialisation of financial instruments – not the way firms are organised.

Finally, according to AMAFI, this new requirement to take into account client's sustainability preference is not an additional risk for investment firms to manage. It should be an additional objective that client may have. Therefore, it does not seem justified to amend MiFID II organisational rules.

Instead, AMAFI suggests adding a new recital. In our point of view, it would address more appropriately the issue. For example, a new recital 29 (bis) could be drafted as follows:

New recital 29 (bis) of MiFD II Delegated Regulation to be added "**Where relevant for advisory process of the clients' firm, sustainability risks should be taken into consideration and reflected as such in the relevant internal procedures**."

4. Preserve the distinction between independent and non-independent investment advice services made in article 52 of MiFID II Delegated Regulation. If AMAFI supports the proposal to take into account sustainability investor preference into its investment objectives for suitability purposes, we feel that the changes proposed in Article 52 of the Draft Delegated Regulation go beyond that objective.

Indeed, the proposed amendments of the article 52, paragraph 3, and particularly the point (d), seem to go beyond that adding of sustainability factors. Indeed, the part of the current applicable provision which applies only to investment firms which provide independent investment advice require them to provide description on the "*factors taken into consideration in the selection process*". With this new wording, elements required in (d) would apply to both investment advice services: non independent and independent. To avoid such extension, AMAFI would suggest another wording for taking into account sustainability factors: in paragraph 2 instead of paragraph 3.

5. Investment in a broader sense. Finally, AMAFI would like to remind that an investment product could be "sustainable" without "directly" invest in an "ESG asset". For instance, this could be the case for a structured product that tracks performance of a basket of shares of companies within energy sector selected on the basis of an environmental or green rating.

Another example could be a product that replicates the value of a "low carbon benchmark" or a "positive carbon impact" as proposed by the Commission in its amendment of Regulation (EU) 2016/1011. Such investment from the investor point of view, promote environmental standard through general promotion of sustainability performances. It could indeed induce companies to reach good ESG rating. Therefore, such "indirect" environmental investment could be considered as suitable for a client that has environmental preference. AMAFI considers that structured products have features which are very useful for investors. One of these features could be ESG promotion in general. It would be highly detrimental for investors and the industry to disqualify structured products from ESG financial instrument definition (see AMAFI's comment in the *Introduction* and its current work on the issue provided in the *Annex*).

AMAFI proposes to slight change the wording of the first definition of article 1.1 to clarify this point.

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AMAFI AMENDMENTS PROPOSALS

To conclude, AMAFI would like to propose the following changes (identified in **<u>bold and underlined</u>** police as being addition and ~~strikeout~~ police as removed) in the proposed Delegated Regulation and will be happy to discuss those further with the European Commission if needed.

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Article 1

1. In Article 2, points (7), (8) and (9) are added:

(7) 'sustainability preferences' means a client's or potential client's choice as to whether either of the following financial instruments should be integrated into his or her investment**, <u>direct or indirect,</u>** strategy:
(a) a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council*;

(b) a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 and that either:

(i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or

(ii) as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in Article 7(1), point (a), of that Regulation;~~ or~~[6]

(8) 'sustainability factors' means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088;

(9) 'sustainability risks' means sustainability risks as defined in Article 2, point (22), of Regulation (EU) 2019/2088~~.~~

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* Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1).";

[6] This deletion is made to correct what we consider a typo.

~~2. in Article 21, paragraph 1 is amended as follows:~~

~~(a) the second subparagraph is replaced by the following: "Investment firms shall take into account sustainability risks when complying with the requirements set out in this paragraph.";~~
~~(b) the following subparagraph is added: "When complying with the requirements set out in this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.";~~

~~3. in Article 23(1), point (a) is replaced by the following:~~

~~"(a) establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems, and, where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall take into account sustainability risks;";~~

4. Article 33 is replaced by the following:

"Article 33

Conflicts of interest potentially detrimental to a client

For the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, including his or her sustainability preferences **<u>if any</u>**, investment firms shall take into account, by way of minimum criteria, whether the investment firm or a relevant person, or a person directly or indirectly linked by control to the firm, is in any of the following situations, whether as a result of providing investment or ancillary services or investment activities or otherwise:
(a) the firm or that person is likely to make a financial gain, or avoid a financial loss, at the expense of the client;
(b) the firm or that person has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client's interest in that outcome;
(c) the firm or that person has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;
(d) the firm or that person carries on the same business as the client;
(e) the firm or that person receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monetary or non-monetary benefits or services.";

5. Article 52, paragraph **<u>2</u>** ~~3~~ is replaced by the following:

<u>2. Investment firms providing investment advice, on an independent or non-independent basis, shall explain to the client the range of financial instruments that may be recommended, including, where relevant, any sustainability factors and its relationship with the issuers or providers of the instruments.</u>

~~3. "Investment firms shall provide a description of:~~

~~(a) the types of financial instruments considered;~~
~~(b) the range of financial instruments and providers analysed per each type of instrument according to the scope of the service;~~
~~(c) when providing independent advice, how the service provided satisfies the conditions for the provision of investment advice on an independent basis;~~
~~(d) the factors, taken into consideration in the selection process used by the investment firm to recommend financial instruments, including risks, costs and complexity of the financial instruments, including any sustainability factors."~~
[*Article 52 paragraph 3 should remain as it is currently written today*]

6. Article 54 is amended as follows:

(a) in paragraph 2, point (a) is replaced by the following:

"(a) it meets the investment objectives of the client in question, including the client's risk tolerance and**, where relevant,** any sustainability preferences";

(b) paragraph 5 is replaced by the following:

"5. The information about the investment objectives of the client or potential client shall include, where relevant, information on the length of time for which the client wishes to hold the investment, his or her preferences regarding risk taking, his or her risk tolerance, the purpose of the investment and his or her sustainability preferences, if any. **Thus, investment firms are required to ask the client about his or her sustainability preferences, but they are not responsible for obtaining or not this information in practice.**"

(c) paragraph 9 is replaced by the following:

"9. Investment firms shall have in place, and be able to demonstrate, that they have in place adequate policies and procedures to ensure that they understand the nature, features, including costs, risks of investment services, and financial instruments selected for their clients, including any sustainability factors, **where relevant,** and that they shall assess, while taking into account cost and complexity, whether equivalent investment services or financial instruments can meet their client's profile."

(d) in paragraph 12, the first subparagraph is replaced by the following:

"12. When providing investment advice, investment firms shall provide a report to the retail client that includes an outline of the advice given and explains how the recommendation provided is suitable for the retail client, including how the recommendation meets the client's investment objectives, his or her personal circumstances with reference to the investment term required, the client's knowledge and experience, the client's attitude to risk, his or her capacity to sustain loss and his or her sustainability preferences **if any**.

Article 2

This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union. It shall apply from [***PO: Please insert a date –*** ~~12~~**18** ***months after publication in the Official Journal of the European Union***].

This Regulation shall be binding in its entirety and directly applicable in all Member States. (…) "

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ANNEX

Decision Tree Diagram for Categorizing Financial Instruments According to ESG Criteria