AFME response to the Commission's amendments to the delegated act supplementing MiFID II on suitability requirements

21 June 2018

General comments

AFME represents wholesale financial market participants operating in Europe and welcomes the Commission's Action Plan on Sustainable Finance.

The funding gap to deliver Europe's decarbonisation efforts is estimated at EUR 180 billion of yearly investments to achieve the EU climate and energy targets by 2030[1]. To fulfil those needs, public finance only "will not be able to meet this challenge" (VP Dombrovskis[2]).

So private sector funding is needed. However, the private sector can only provide the necessary additional finance through developed capital markets. Although EU initiatives such as the Capital Markets Union (CMU) and the Investment Plan for Europe have been helpful, Europe generally still relies heavily on bank lending. Policy actions in the context of the CMU will therefore have to encourage private investments and increase this focus on a sustainable finance framework. Therefore, it is vital that the EU continues its work on the CMU to build Europe's capital markets capacity, jointly with the banking sector capacity.

Many CMU initiatives were successful in removing obstacles for issuers and investors to access capital markets. Additional work is necessary to increase allocation towards sustainable investments, for instance by further developing the green securitisation market, enhancing the European pension investments and reviewing incentives to promote equity financing.

Specific comments to the Commission's proposal

Overall, we support the objectives to improve the flow of ESG information so that clients make better informed sustainable investment decisions. We agree that clients should receive clear and transparent information regarding the nature of the investment they are contemplating, when relevant.

Importance of developing the EU classification system first

A workable, flexible and dynamic taxonomy is a pivotal initiative which should be achieved prior to any important review of existing financial regulations, including MiFID II. We believe that the progressive development of a sustainability taxonomy with strong involvement from sustainability and financial market experts is a pre-requisite to achieve the objective of integrating ESG considerations into the investment and advisory process in a consistent manner across sectors.

Any attempt to rush the incorporation of ESG considerations within the MiFID II suitability assessment without a rigorous process which includes phasing requirements, longer implementation times and more consultation with industry participants will harm the overall objective of the Commission's action plan. More concretely, without the establishment of the EU taxonomy first, firms providing investment advice and

[1] Financing sustainable growth, Action Plan, European Commission
[2] VP Dombrovskis speech on sustainable finance at the European Parliament, 6 June 2017

portfolio management would not have clear, common criteria to use to ascertain the degree of an investment's sustainability and compare these investments appropriately. Implementing changes to the MiFID II suitability rules to require financial advisers to integrate sustainability into their suitability assessments without an established EU taxonomy would lead to inconsistent and divergent comparisons of sustainable investments and could increase the 'greenwashing' risks which the EC is trying to tackle. We therefore believe that any potential changes to the MIFID II suitability rules should reference the EU taxonomy Regulation and should take account of the granularity of the taxonomy and how dynamic it is. In this respect, it will be important to ensure that the EU taxonomy is designed in a way that takes into consideration that firms providing investment advice and portfolio management will have to use this taxonomy to identify and implement their clients' possible ESG preferences as part of the MIFID II suitability assessment or a separate ESG taxonomy specifically tailored for the MIFID II suitability requirements will have to be developed. We are therefore concerned that the Commission's envisaged timeline of implementing these requirements 18 months after coming into force will not allow sufficient time to develop and refine a taxonomy that can be widely adopted by the industry.

In addition, for these changes to be successful it would be important to have sufficient supply of investment products available to address the varied sustainability related requirements from clients, once these preferences have been articulated. The establishment of an EU taxonomy and creating standards and labels for investments products are therefore crucial enabling factors for the success of this initiative. It is also important that the Commission establish a comprehensive set of common definitions of ESG factors. In addition to introducing a common language around environmental sustainability, the Commission should do the same for Social and Governance before requiring firms to incorporate these aims into suitability assessments. Alternatively, should the scope of the EU Taxonomy Regulation be limited as a first step to climate change and environmentally sustainable activities - as currently envisaged by Commission, firms providing investment advice and portfolio management should accordingly only be required to seek and consider the possible 'Environment' preferences of their clients as part of the MIFID II suitability assessment.

AFME is planning to respond separately to the Commission's other proposals on sustainable finance, including the EU taxonomy.

More specifically, AFME would like to ask for clarifications on the six points below. Specific amendments are also suggested in the annex.

1. Consistency with other regulations

a. Consistency in definitions

While the Taxonomy Regulation, which VP Dombrovskis had argued was the "common trunk from which other actions will branch off"[3], introduces definitions of an environmentally sustainable investment (referring to the "E" in ESG). However, definitions of "social investment" and "good governance investment" are being added in the MiFID II proposal.

Such inconsistencies mean that a classification for "social investment" and "good governance investment" would need to be developed by individual market participants which risks the fragmentation of the market as well as risks of "clean washing".

[3] Speech by VP Dombrovskis, High-Level Conference on Financing Sustainable Growth, 22 March 2018

Moreover, ESG can have different meanings. The current wording of ESG considerations imply that only ESG investment preferences that have stated positive environmental or societal objective are included although other types of considerations could be take into account, such as for instance negative screening. AFME will provide separately further comments to the Taxonomy Regulation in response to the Commission's proposal.

We strongly support the objective of the Taxonomy Regulation to provide "unified definitions and enable reliable and comparable information on sustainable investments" with "[t]he aim […] to embed the future EU sustainability taxonomy in EU law and provide the basis for using such a classification system in different areas"[4]. Therefore, we strongly believe that any potential changes to the MiFID II rules should follow the definitions to be introduced by the Taxonomy Regulation thus minimising the risk of divergence and fragmentation in the market.

b. Consistency in scope

The Taxonomy Regulation's current scope (limited to environmentally sustainable activities) is on "financial market participants offering financial products as environmentally sustainable investments" while MiFID II is a comprehensive set of rules for investment firms on investment services, activities and financial instruments.

The Taxonomy Regulation needs to clearly define whether the sustainability consideration obligations should be applied to the market participants or to qualifying financial instruments. From a market perspective we recommend the provisions are implemented on financial instrument level and further recommend that the provisions are only applied to certain types of financial instruments, where relevant. For instance, some financial instruments – such as interest rate derivatives and currency derivatives – are often used to hedge risks arising from companies' normal commercial activities. Therefore, it may not be relevant to consider sustainability preferences when advising customers on these financial instruments - and it may even be impossible in the sense that it is difficult to see, for example, how a currency transaction5 or interest rate swap should be ESG classified.

2. Scope of the amendments – Application to retail clients and professional clients

The proposals will only apply to 'retail clients' who have been classified as such under the MiFID II existing suitability requirement. According to ESMA's final advice, the only "retail-like" obligations which extends to communications with professional clients are the following three items:

i. information must not reference potential benefits without a fair and prominent indication of relevant risks;
ii. information must not disguise, diminish or obscure important items, statements or warning; and
iii. information must be accurate and up-to-date, taking account of the communication method used.

Further, the HLEG in its final report from 31st January 2018 recommended that investment advisers should be required "to ask about, and then respond to, retail investors' preferences about the sustainable impact of their investments, as a routine component of financial advice".

[4] Commission Action Plan on Sustainable Finance, 8 March 2018
[5] As an example: How should a currency like USD or EUR be ESG classified? And how should a currency transaction involving two currencies – for example where a client buys USD and pays with EUR – be ESG classified?

In order to ensure consistency and continuity with existing MiFID II approach, **we recommend that the ESG considerations and preferences apply to the existing scope of retail clients.**

3. Scope of the amendments – Application

We would welcome additional information on whether the new provisions would apply to:

i. the entire back-book and all new clients: this option would represent an important repapering exercise which will necessitate significant time to implement; or
ii. new clients advice only (including whether this is product specific); or
iii. new clients and new advice/products for old clients.

4. Appropriateness of a recommendation

Article 48 is a general requirement to provide clients or potential clients information about financial instruments that applies for all investment services even where no suitability requirement could apply. Many of those potential clients would not be provided portfolio management or investment advice services and are out of scope of suitability requirements. Therefore, we propose specific amendments to Article 48 (see table below).

In addition, according to Article 54 as currently amended by the Commission, no recommendation or investment decision could be made where no suitable sustainable investment is available. Investor interest would be better served if ESG preferences are not a requirement for the suitability of the investment rather taken into account by investment firms. Therefore, we propose specific amendments to Article 54 (see table below).

5. Assessment of ESG preferences

A consistent language is fundamental to deliver better and consistent ESG disclosures to help investors make more informed choices. We would question the efficacy of mandating incorporation of ESG factors into suitability requirements before the taxonomy is established, tested and accepted for all sustainability objectives (environment and social). **Clients and investment firms must be able to have a conversation on the same terms, otherwise the ability to demonstrate best efforts to meet client preferences could be compromised, creating significant legal risk for firms.**

6. Timing

MiFID II has just been implemented and any changes affecting clients require extensive updates to systems, controls and contracts as well as education of clients and advisors to understand ESG factors.

As stated above, we have concern that the Commission's timeline for implementing the proposed amendments to MiFID II is ambitious, and should not front run the establishment of a developed and refined taxonomy. The Commission should not aim to make hasty changes to MIFID II suitability rules - before the establishment of the EU taxonomy- which will likely require making further changes to the suitability rules once the taxonomy is effective. In addition, ESMA is required to review MiFID II by 3 March 2020. While the proposed MiFID II changes under the sustainable finance initiative would come into force in September 2020, similar areas are expected to be updated again in February 2021 with similar impacts on clients and firms. Changes to MIFID II rules should be minimised in order to manage the burden and related costs on firms and clients alike.

Annex: Proposed AFME amendments[6]

Recital 1	On 25 September 2015, the UN General Assembly adopted a new global sustainable development framework: the 2030 Agenda for Sustainable Development having at its core the Sustainable Development Goals (SDGs). The Commission's Communication of 2016 on the next steps for a sustainable European future links the SDGs to the Union policy framework to ensure that all Union actions and policy initiatives, within the Union and globally, take the SDGs on board at the outset. The European Council conclusions of 20 June 2017 confirmed the commitment of the Union and the Member States to the implementation of the 2030 Agenda for Sustainable Development in a full, coherent, comprehensive, integrated and effective manner and in close cooperation with partners and other stakeholders.
Recital 2	In 2016 the Union concluded the Paris Climate Agreement. Article 2(c) of the Agreement sets the objective to strengthen the response to climate change, among other means by making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.
Recital 3	Sustainability and the transition to a low-carbon and climate resilient, more resource-efficient and circular economy are key in ensuring long-term competitiveness of the Union's economy. Sustainability has long been at the heart of the European Union project and the Unions Treaties give recognition to its social and environmental dimensions.
Recital 4	On 8 March 2018, the Commission published its Action Plan 'Financing Sustainable Growth' setting out an ambitious and comprehensive strategy on sustainable finance. One of the objectives of that Action Plan is to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth.
Recital 5	Decision No. 1386/2013/EU of the European Parliament and of the Council called for an increase in private sector funding for environmental and climate-related expenditure, notably through putting in place incentives and methodologies that encourage companies to measure the environmental costs of their business and profits derived from using environmental service.
Recital 6	Directive 2014/65/EU establishes an obligation for investment firms to act in accordance with the best interests of their clients. As part of that obligation, investment firms providing investment advice and portfolio management are required to obtain information regarding the client's or potential client's knowledge of and experience in the investment field, and his or her financial situation and investment objectives, including his or her risk tolerance. Delegated Regulation (EU) 2017/56517 sets out that

[6] Changes are in red text.

	information on investment objectives should include information about the length of time, for which a client wishes to hold an investment, his or her preferences regarding risk taking, his or her risk profile, and the purposes of the investment.
Recital 7	To better identify the client's investment objectives, it should be clarified what consideration investment firms should give to Environmental, Social and Governance (ESG) preferences in the investment and advisory process.
Recital 8	There is a divergence in how investment firms providing investment advice and portfolio management integrate ESG considerations in their suitability assessments, which leads to uncertainties and confusion for investors. To improve the functioning of the internal market, the way those investment firms integrate ESG considerations into the suitability assessment should be harmonised.
Recital 9	To enable those investment firms to recommend the most suitable products to the client, investment firms providing investment advice and portfolio management should introduce questions in their suitability assessment that would help identify the client's investment objectives, including ESG preferences. The final recommendations to the client should reflect both the financial objectives and, where relevant, the ESG preferences of that client. Investment firms providing investment advice and portfolio management should consider each client's individual ESG preferences on a case-by-case basis. Investment firms should offer those financial products that correspond to the ESG preferences of the client **where available**, in accordance with their obligation to act in the best interests of the client.
Recital 10	To enable clients to make well-informed investment decisions, investment firms should disclose, where relevant, information on the ESG **considerations** ~~**preferences**~~ of each financial product offered to clients before providing investment services.
Recital 11	Investment firms providing portfolio managem**e**nt should provide the client with information about the types of financial instrument that may be included in the client **portfolio** ~~**protfolio**~~ and types of transaction that may be carried out in such instruments. As part of this obligation, investment firms should also explain how client’s ESG preferences are taken into account in the process of selecting financial instruments for client’s portfolio.
Recital 12	Investment firms should also explain to the client how his or her ESG preferences for each financial instrument is taken into consideration in the selection process used by those firms to recommend financial products.

Recital 13	To allow investment firms to adapt to the new requirements contained in this Regulation so that they can be applied in an efficient and effective manner, this Regulation should apply 18 months after the date of its entry into force.
Article 1(1) amending Article 2	In Article 2, points (7), (8)**,** ~~and~~ (9)**, (10) and (11)** are added: (7) 'ESG preferences' means a client's or potential client's preferences for environmentally sustainable investments, social investments or good governance investments; (8) 'ESG considerations' means a consideration related to environmentally sustainable investments, social investments or good governance investments'; (9)'environmentally sustainable investment' means an investment in an economic activity that contributes to an environmental objective, and in particular an environmentally sustainable investment as defined in Article 2 of [insert reference to taxonomy Regulation] (10) 'social investment' means an investment in an economic activity that contributes substantially to a social objective, and in particular an investment that contributes to tackling inequality, an investment fostering social cohesion, social integration and labour relations, and an investment in human capital or economically or socially disadvantaged communities; (11) 'good governance investment' means an investment in companies following good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance.”;
Article 1(2) amending Article 47(3)(d)	In Article 47(3), point (d) is replaced by the following: "(d) the types of financial instrument that may be included in the client portfolio, based on the client's investment objectives, including any ESG preferences**, where relevant**, and the types of transaction that may be carried out in financial instruments, including any limits;."
Article 1(3) amending Article 48(1)	In Article 48(1), the first sentence is replaced by the following: "Investment firms shall provide clients or potential clients in good time before the provision of investment services or ancillary services to clients or potential clients with a general description of the nature and risks of financial instruments, taking into account **including** ~~in particular~~ any the client's categorisation as either a retail client, a professional client or eligible counterparty."
Article 1(4) amending Article 52(3)	Article 52, paragraph 3 is replaced by the following: 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, such as risks, costs and complexity of the financial instruments or, where relevant, ESG considerations."
Article 1(5) amending Article 54	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 **takes into consideration** any preferences, including environmental, social and governance considerations **where relevant**"; (b) paragraph 5 is replaced by the following: "5. The information regarding 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 ESG preferences, if any, his or her preferences regarding risk taking, his risk profile, and the purposes of the investment". (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 environmental, social and governance considerations,**~~ and that they shall assess, while taking into account cost and complexity **and environmental, social and governance preferences, if any**, whether equivalent investment services or financial instruments can meet their client's profile." (b) paragraph 12 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 objectives, including ESG preferences, if any,**~~ and personal circumstances with reference to the investment term required, the client's knowledge and experience, and client's attitude to risk and capacity for loss. **The report shall also include a reference to whether or not the recommendation meets the client's ESG preferences, if any**"
Article 2	1. This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union. 2. This Regulation shall apply [insert date: 18 months after the date of entry into force]. 3. This Regulation shall be binding in its entirety and directly applicable in all Member States.

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About AFME:
AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.