afme/ Finance for Europe

ISDA. Safe, Efficient Markets

Supplementary Response

The European Commission's draft delegated acts (amending Delegated Directive (EU) 2017/593 to integrate sustainability factors and preferences into the product governance obligations, and amending Delegated Regulation (EU) 2017/565 to integrate sustainability factors, risks and preferences into certain organisational requirements for investment firms)

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AFME and ISDA ('the Associations', also 'we', 'our', 'us') support the objectives of the EU's action plan on sustainable finance, including ensuring that investors have clear information on the environmental, social and governance (ESG) risks and opportunities associated with their investments.

Further to our primary response to the Commission's consultation[1] (available here), we have set out below our views on the proposed definition of "sustainability preferences" in Article 1(5) of the draft Delegated Directive and Article 2(7) of the draft Delegated Regulation "together, the "**draft Delegated Acts**"), particularly with respect to how Articles 8 and 9 of the Disclosure Regulation should be applied to financial instruments.

In summary, we think that the definition, as currently drafted, will restrict clients' choice of products with sustainability features to narrow categories of financial instruments. Though we understand the Commission's concerns around the risk of greenwashing, we think it should be tackled by providing clear disclosures to clients about the ESG features of their investments rather than by limiting the universe of investment products that can be offered under MiFID II. We also think that the proposed definition will create confusion for clients where some products marketed as promoting environmental and social characteristics under the Disclosure Regulation may not be allowed to be offered to clients under MiFID II.

We thus recommend that the Commission:

- Ensures that "sustainability preferences" are not be limited to "Financial Products" under the Disclosure Regulation.

- Aligns the categorization of financial products in the proposed amendments to MiFID II with that in the Disclosure Regulation (by deleting the references to Articles 2 and 7 of the Disclosure Regulation in the definition of sustainability preferences).

<u>Background - Definition of Sustainability Preferences in the Draft Delegated Acts</u>

The definition of sustainability preferences in the draft Delegated Directive and draft Delegated Regulation (set out below) appears to introduce new subcategories of sustainable financial instruments when read in the context of the products set out in Regulation (EU) 2019/2088 (the Disclosure Regulation).

> "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 strategy:
>
> - 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*;
>
> - a financial instrument that **promotes environmental or social characteristics** as referred to in **Article 8** of Regulation (EU) 2019/2088 **and** that **either**:

[1]https://www.afme.eu/Portals/0/DispatchFeaturedImages/20200706%20AFME%20ISDA%20response%20to%20the%20European%20Commission's%20MiFID%20II%20delegated%20acts%20(product%20governance%20and%20suitability)%20(002).pdf

(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;" [*Emphasis added*]

The first bullet point of the definition, by referring to a financial instrument's "objective", describes a financial instrument that qualifies as an **Article 9 financial product** under the Disclosure Regulation (which states that "Where a financial product has sustainable investment as its objective…the information to be disclosed…shall be accompanied by the following…").[2]

The second bullet point appears to introduce a new category of financial instruments that has features that are derived from Article 8.1 of the Disclosure Regulation (i.e., promoting environmental or social characteristics) **and** also reflects one of **either**: (1) an **Article 9 financial product** under the Disclosure Regulation (the reference to "pursues" in point "i" is akin to the phrase "as its objective" in Article 9 of the Disclosure Regulation), **or** (2) a requirement that, as of 30 December 2022, financial market participants make product level disclosures for each financial product where the participant considers **principal adverse impacts of investment decisions** on sustainability factors (see Article 7 of the Disclosure Regulation).

<u>Issues</u>

We are concerned that the Commission's proposed approach would essentially limit the scope of Article 1(5) of Delegated Directive (EU) 2017/593 so that the only products that a firm could take into account in determining a client's "sustainability preferences" would be products that fall within either Article 9 of the Disclosure Regulation or the subcategory of financial instruments with features from Article 8.1 of the Disclosure Regulation and which satisfy one of the two proposed requirements (i.e., related to Article 9 financial products or principal adverse impacts under Article 7 of the Disclosure Regulation).

This would have major consequences with direct detrimental impact on the general EU policy goal of mainstreaming ESG products:

- first, while the definition of "sustainability preferences" refers to "financial instruments", the cross references to Article 9 of the Disclosure Regulation and the subcategory of financial instruments with features from Article 8.1 of the Disclosure Regulation would limit this definition to financial instruments which qualify as "financial products" under the Disclosure Regulation (i.e., managed portfolios, AIFs, IBIPs, pension products and pension schemes, UCITS and PEPPs). This would mean that a client's "sustainability preferences" could not encompass products such as bonds, equity shares, derivatives, complex products and others.

- second, the Commission's proposed product scope definition regarding the determination of sustainability preferences creates the unnecessary and potentially harmful misalignment of definitions between the Disclosure Regulation and the draft Delegated Acts. Article 8 of the Disclosure Regulation clearly refers to products that, among other characteristics, promote environmental or social characteristics, or their combination. However, as described in detail in the Background section, the definition of sustainability preferences in the draft Delegated Acts introduces additional features to such products. It appears that the products promoting environmental and/or social characteristics would also need to either pursue sustainable investment (effectively making them Article 9 products which are already included in the definition as per the first bullet point) or specifically consider principal adverse impacts on sustainability factors (we note that the Disclosure Regulation provides an exemption from consideration of principal adverse impacts to firms with fewer than 500 employees).

[2] See Article 9(1) of the Disclosure Regulation, available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN

We are concerned that such a misalignment will significantly restrict the range of financial instruments that promote environmental and social characteristics because the related products might not be allowed to be offered to clients under MiFID II whilst still being allowed to be marketed under the EU Disclosure Regulation as products that promote environmental and social characteristics.

Proposed Action

We would suggest that the Commission:

1. Amend Article 1(5) of the draft Delegated Directive 2017/593 to make it explicit that the cross references are only made to relevant defined terms in the Disclosure Regulation (e.g., "sustainable investments") and that that the definition of "sustainability preferences" in Article 1(5) is not intended to be limited to "financial products" within scope of the Disclosure Regulation.

2. Amend Article 1(5) of the draft Delegated Directive 2017/593 to delete the references (in the second bullet point of the article) to Articles 2 and 7 of the Disclosure Regulation, which would avoid creating a subcategory of Article 8 (Disclosure Regulation) criteria on which a client's sustainability preferences could be based.

   The above recommendations will allow clients to access a broader range of financial instruments with sustainability features. It would also help to avoid confusion for clients who might question why certain products promoting environmental and social characteristics (as marketed) cannot be included in their investment portfolios based on their respective sustainability preferences. The recommendations will also help promote consistency of concepts and definitions between the different pieces of legislation.

3. Amend Article 2(7) of draft Delegated Regulation (EU) 2017/565 according to the above recommendations.

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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.

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About ISDA
Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 74 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.