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EUROPEAN
COMMISSION

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COMMISSION DELEGATED REGULATION (EU) …/...

of XXX

amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

(Text with EEA relevance)

This draft has not been adopted or endorsed by the European Commission. Any views expressed are the preliminary views of the Commission services and may not in any circumstances be regarded as stating an official position of the Commission.

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

This Regulation is part of a broader Commission's initiative on sustainable development. It lays the foundation for an EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system in line with the **European Green Deal**[1] objectives.

Following the adoption of **2016 Paris agreement on climate change** and **the United Nations 2030 Agenda for Sustainable Development Goals (SDGs)**, the Commission announced in the **Action Plan: Financing Sustainable Growth**[2] the intention to incorporate sustainability when providing financial advice and to clarify the integration of sustainability in so-called fiduciary duties in sectoral legislation. The **European Green Deal** Communication confirms the need for long-term signals to direct financial and capital flows to green investment and to avoid stranded assets. This Delegated Regulation will contribute to this specific objective.

Commission Delegated Regulation (EU) 2017/565 supplements Directive 2014/65/EU (MiFID II) by further specifying organisational requirements and operating conditions for investment firms. This Regulation modifies Commission Delegated Regulation (EU) 2017/565 in two ways:

First, it integrates sustainability factors in the suitability assessment. Under the existing MiFID II framework, firms providing investment advice and portfolio management are required to obtain the necessary information about the client's knowledge and experience in the investment field, their ability to bear losses, and objectives including the client's risk tolerance to enable the firm to provide services and products that are suitable for the client (suitability assessment). The information regarding the investment objectives of the client includes information on the length of time for which the client wishes to hold the investment, his/her preferences regarding risk taking, risk profile, and the purposes of the investment. However, the information about investment objectives generally relates to financial objectives, while non-financial objectives of the client, such as sustainability preferences, are usually not addressed. Existing suitability assessments generally do not include questions on clients' sustainability preferences, while the majority of the clients would not raise such preferences themselves. As a result, investment firms consistently do not give appropriate consideration to sustainability factors in the selection process.

Second, this Regulation integrates sustainability risks into the organisational requirements. This part on the sustainability risk is based on a Final Report on technical advice[3] by the European Securities and Markets Authority (ESMA). The technical advice concludes that further clarifications are needed in respect of the integration of sustainability risks and sustainability factors in Commission Delegated Regulation (EU) 2017/565 and Commission Delegated Directive 2017/593 and identifies specific provisions in this respect.

This Regulation and other sectoral delegated acts that adapt rules on fiduciary duties and that were adopted alongside also reinforce the **Regulation on sustainability-related disclosures**

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[1] Communication from the Commission to the European Parliament, to the European Council, the Council, the European Economic and Social Committee, and the Committee of the Regions: the European Green Deal (COM(2019)640 final)

[2] Communication from the Commission to the European Parliament, to the European Council, the Council, The European Central Bank, the European Economic and Social Committee, and the Committee of the Regions Action Plan: Financing Sustainable Growth (COM(2018)097 final).

[3] Final report on integrating sustainability risks and factors in the MIFID II (ESMA35-43-1737).

in the financial services[4], **the Regulation on the EU Climate Transition Benchmarks and the EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks**[5] and **the Regulation on the EU taxonomy for sustainable activities**[6]. These rules integrate sustainability considerations into the investment, advisory and disclosure processes in a consistent manner across sectors. They anchor environmental, social and governance (sustainability) considerations at the heart of the financial system to help transform Europe's economy into a greener, low-carbon, more resilient, resource-efficient and circular system.

This Regulation is based on the empowerment set out in Articles 16, 24(13) and 25(8) of MiFID II.

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In December 2016, the Commission set up a High-Level Expert Group on Sustainable Finance (HLEG) to help develop an EU strategy on Sustainable Finance through recommendations. The HLEG published an interim report on "Financing a Sustainable European Economy" in mid-July 2017 and presented its final report at a stakeholder event on 18 July 2017, followed by a consultation questionnaire.

A feedback statement that was published along with the HLEG final report on Financing a Sustainable European Economy on 31 January 2018 summarises the respondents' answers. In its final report, the HLEG recommends to "*require investment advisers to ask about, and then respond to, retail investors' preferences about the sustainable impact of their investments, as a routine component of financial advice*". It also recommended to "*discuss the governance of addressing long-term and sustainability risks".*

In March 2018, the Commission sent a targeted questionnaire on the integration of environmental, social and governance considerations in the suitability assessment. The consultation showed that only a minority of the clients proactively raise sustainability issues during the advisory process. Some of the reasons for this are: i) the available information on sustainability-related financial products is not transparent; ii) the risk of 'greenwashing' in existing documentation is high; and iii) there is a lack of education on its impact on risk and performance. Only in rare cases, clients seem to systematically raise interest in sustainability factors during the advisory process.

In addition, the draft Delegated Regulation amending the suitability assessment was published for feedback in line with the Better Regulation guidelines in the period between 24 May and 21 June 2018. The Commission received 51 answers referring to this Delegated Regulation amending Regulation (EU) 2017/565. Stakeholders from different backgrounds (e.g. NGOs, financial industry associations, public bodies)[7] commented on diverse aspects of this Delegated Regulation. While there was generally strong support to enhance the focus on non-financial objectives within the investment process, some stakeholders were reluctant to change their newly implemented processes based on MiFID II. As described above, the Commission is not only convinced of the urgency of moving ahead with its Sustainable

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4 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).

5 Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (OJ L 317, 9.12.2019, p. 17).

6 Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (not yet published).

7 The feedback received is published on: https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-2681500/feedback_en

Finance Agenda but is also of the view that the newly introduced reference to Regulation (EU) 2019/2088 on sustainability- related disclosures in the financial services sector[8] proposed timeline for the application of this delegated act (12 months after entry into force) provides for sufficient flexibility.

As regards some of the objectives within the suitability assessment process, the Commission included some modifications in order to allow for the necessary differentiation between investment objectives on the one hand and sustainability preferences on the other hand. This differentiation is important in order to avoid mis-selling, which may happen should a sustainability factors take precedence over a client's personal investment objective. Another recital should then clarify that the sustainability preferences should only be addressed within the suitability process once the client’s investment objective has been identified.

To enhance legal certainty, the references to sustainable investments were specified and the recitals were amended: it was clarified that a new suitability assessment for existing contracts will generally not be necessary.

The Commission requested ESMA to issue a technical advice on potential amendments to delegated acts to be adopted under the MiFID II with regard to the integration of sustainability risks and sustainability factors in the areas of organisational requirements, operating conditions, risk management and target market assessment.

On 30 April 2019, ESMA published its “Final report on integrating sustainability risks and factors in MiFID II”. The advice took into account the views expressed by stakeholders during the public consultation between 19 December 2018 and 19 February 2019. It includes a cost-benefit analysis. In addition, ESMA carried out an open public hearing on 4 February 2019 in order to gather additional feedback. The Securities and Markets Stakeholder Group of ESMA was also consulted.

This report addresses the inclusion of sustainability risks and sustainability factors into the organisational requirements and product governance and oversight structures of investment firms. The recommendations on organisational requirements prepared and publicly consulted by ESMA were integrated into this Delegated Regulation.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

The legal basis for this Regulation is set out in Article 16(12), Article 24(13) and Article 25(8) of Directive 2014/65/EU.

This Regulation covers the following amendments to Regulation (EU) 2017/565:

Article 1 aims at clarifying that investment firms providing financial advice and portfolio management should carry out a mandatory assessment of sustainability preferences of their clients. These investment firms should take these sustainability preferences into account in the selection process of the financial products that are offered to these clients. Further, it requires investment firms to prepare a report to the client that explains how the recommendation to this client meets his investment objectives, risk profile, capacity for loss bearing and sustainability preferences (ex-post information disclosure).

In addition, Article 1 requires investment firms to take into account sustainability risks when complying with the organisational requirements and to integrate sustainability risk into the risk management policies.

8 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).

Finally, Article 2 sets out the date of application of this Regulation, including the transitional period of 12 months.

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THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to 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[9], and in particular Article 16(12), Article 24(13) and Article 25(8) thereof,

Whereas:

(1) The transition to a low-carbon, more sustainable, resource-efficient and circular economy in line with the Sustainable Development Goals is key to ensuring the long-term competitiveness of the economy of the Union. In 2016, the Union concluded the Paris Agreement. Article 2(1), point (c), of the Paris Agreement sets out the objective of strengthening the response to climate change by, among others, making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

(2) Recognising that challenge, the Commission presented the European Green Deal in December 2019. That Green Deal represents a new growth strategy that aims to transform the Union into a fair and prosperous society with a modern, resource-efficient and competitive economy where there are no net greenhouse gas emissions from 2050 onwards and where economic growth is decoupled from resource use. That objective requires that clear signals are given to investors with regard to their investments to avoid stranded assets and to raise sustainable finance.

(3) In March 2018, the Commission published its Action Plan 'Financing Sustainable Growth'[10], setting up an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in the Action Plan is to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth. The impact assessment underpinning subsequent legislative initiatives published in May 2018[11] demonstrated the need to clarify that sustainability factors should be taken into account by investment firms as part of their duties towards clients. Investment firms should therefore consider not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks as referred to in Regulation (EU) 2019/2088 of the

[9] OJ L 173, 12.6.2014, p. 349.
[10] COM(2018) 97 final.
[11] SWD(2018) 264 final.

European Parliament and of the Council[12] that, where they occur, could cause an actual or potential material negative impact on the value of an investment. Commission Delegated Regulation (EU) 2017/565[13] does not explicitly refer to sustainability risks. For that reason and to ensure that internal procedures and organisational arrangements are properly implemented and adhered to, it is necessary to clarify that processes, systems and internal controls of investment firms reflect sustainability risks, and that technical capacity and knowledge is necessary to analyse those risks.

(4) To maintain a high standard of investor protection, investment firms should, when identifying the types of conflicts of interest the existence of which may damage the interests of a client, include those types of conflicts of interest that stem from the distribution of sustainable investments or from investments that promote environmental or social characteristics.

(5) Investment firms that provide investment advice and portfolio management should be able to recommend suitable products to their clients and should therefore be able to ask questions to identify the client's individual sustainability preferences. In accordance with the investment firm's obligation to act in the best interest of its client, recommendations to clients should reflect both the financial objectives and any sustainability preferences expressed by those clients. It is therefore necessary to clarify that investment firms should have in place appropriate arrangements to ensure that the inclusion of sustainability factors in the advisory process and portfolio management does not lead to mis-selling practices or to the misrepresentation of instruments or strategies as fulfilling sustainability preferences where they do not. In order to avoid such practices or misrepresentations, investment firms providing investment advice should first assess the investor's' investment objectives, time horizon and individual circumstances, before asking their clients for their potential sustainability preferences.

(6) Sustainable products with various degrees of ambition have been developed so far. To enable clients to better understand those products, investment firms that provide investment advice and portfolio management services should clearly explain the distinction between financial products that promote environmental or social characteristics and financial products that pursue sustainable investment objectives. Whilst financial products that pursue sustainable investment objectives guarantee the attainment of certain level of sustainability, financial products that promote environmental or social characteristics do not necessarily achieve that. That is why the identification of the client's sustainability preferences should in case of financial products that promote environmental or social characteristics take into account those financial products that at least to some extent pursue sustainable investment objectives, or consider principal adverse impacts on sustainability factors, as laid down by Regulation (EU) 2019/2088. Since, in accordance with that Regulation, certain manufacturers of financial products should be obliged to provide information on how their financial products consider principal adverse impacts on sustainability factors at the latest as of 30 December 2022, investment firms should be able to

[12] 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).

[13] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 87, 31.3.2017, p. 1).

increasingly recommend also those products as suitable in terms of clients' sustainability preferences after that day.

(7) Delegated Regulation (EU) 2017/565 should therefore be amended accordingly.

(8) Competent authorities and investment firms should be given sufficient time to adapt to the new requirements contained in this Regulation. Its application should therefore be deferred,

HAS ADOPTED THIS REGULATION:

Article 1

Delegated Regulation (EU) 2017/565 is amended as follows:

(1) in Article 2, the following 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 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

(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).";

(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, 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) in 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, including risks, costs and complexity of the financial instruments, including any sustainability factors.”;

(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 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 about 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.";

(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, 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 losses and his or her sustainability preferences.";

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 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.

Done at Brussels,

For the Commission
The President
Ursula von der Leyen