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COMMISSION DELEGATED REGULATION (EU) …/...

of XXX

amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management

(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 proposal is part of a broader Commission's initiative on sustainable development. It lays the foundation for an EU framework which puts Environmental, Social and Governance (ESG) considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system. ESG factors should be considered in the investment decision making process to make investments more sustainable when taking into account gas emissions, resource depletion, or working conditions. The legislative acts aim at integrating ESG considerations into the investment and advisory process in a consistent manner across sectors. This should ensure that all financial entities that receive a mandate from their clients or beneficiaries to take investment decisions on their behalf would integrate ESG into their internal processes and inform their clients about it. Such requirements would apply for example to asset managers, insurance companies, pension funds, or investment advisors. Furthermore, to help investors compare the carbon footprint of investments, the proposals introduce new categories of low carbon and positive carbon impact benchmarks. These proposals which are mutually reinforcing should facilitate investments in sustainable projects and assets across the EU.

The Commission's package follows global efforts towards a more sustainable economy. Governments from around the world chose a more sustainable path for our planet and our economy by adopting the **2015 Paris agreement on climate change** and the **United Nations (UN) 2030 Agenda for Sustainable Development.**

The EU is committed to a development path that meets the needs of the present without compromising the ability of future generations to meet their own needs. Sustainability has since long been at the heart of the European project. The EU Treaties give recognition to its social and environmental dimensions, which should be addressed together.

The 2016 Commission's Communication on the next steps for a sustainable European future links the Sustainable Development Goals (SDGs)[1] of the UN 2030 Agenda for Sustainable Development to the European policy framework to ensure that all EU actions and policy initiatives, within the EU and globally, take the SDGs on board at the outset. The EU is also fully committed to reaching the EU 2030 climate and energy targets and to mainstream sustainable development into EU policies, as announced in the 2014 **Political Guidelines for the European Commission**[2] by Jean-Claude Juncker. Therefore, many of the European Commission's policy priorities for 2014-2020 feed into the EU climate objectives and implement the 2030 Agenda for Sustainable Development. These include the **Investment Plan for Europe**[3], the **Circular Economy Package**, the **Energy Union package**, the **Capital**

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[1] The 17 SDGs provide qualitative and quantitative objectives for the next 15 years to prepare ourselves for the future and work towards human dignity, stability, a healthy planet, fair and resilient societies and prosperous economies.

[2] A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change - Political Guidelines for the next European Commission, Strasbourg, 15 July 2014 available at:

[3] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank: An Investment Plan for Europe (COM(2014) 0903 final).

Markets Union[4] and the **EU budget for 2014-2020**, including the **Cohesion fund** and research projects. In addition, the Commission launched a multi-stakeholder platform to follow-up and exchange best practices on SDGs implementation.

Achieving EU sustainability goals requires important investments. In the climate and energy space alone, it is estimated that an additional annual investment of EUR 180 billion is needed to meet climate and energy targets by 2030.[5] A substantial part of these financial flows will have to come from the private sector. Closing this investment gap means significantly reorienting private capital flows towards more sustainable investments and requires a comprehensive rethinking of the European financial framework.

In this context, the Commission established in December 2016 a **High-Level Expert Group (HLEG)** to develop a comprehensive EU strategy on sustainable finance. The HLEG published its final report[6] on 31 January 2018. This report provided a comprehensive vision on sustainable finance for Europe and identified two imperatives for Europe's financial system. The first is to improve the contribution of finance to sustainable and inclusive growth. The second is to strengthen financial stability by incorporating Environmental, Social and Governance (ESG) factors into investment decision-making). The HLEG issued eight key recommendations, which it believes are essential building blocks of a sustainable European financial system. Among these recommendations, the HLEG calls for the establishment of a technically robust classification system at EU level to provide clarity on what is 'green' or 'sustainable' – a so-called sustainability taxonomy.

To follow-up on the work of the HLEG and contribute to broader efforts to connect finance with the needs of the planet and society, the Commission published on 8 March 2018 an **Action Plan on Financing Sustainable Growth**[7]**.** It announced that the Commission would amend the delegated acts under Directive 2014/65/EU on markets in financial instruments (MiFID II)[8] and Directive (EU) 2016/97 on insurance distribution (IDD)[9] to ensure that sustainability preferences are taken into account in the suitability assessment.

The Action Plan also indicated that *“based on these delegated acts, the Commission will invite the European Securities Markets Authority (ESMA) to include provisions on sustainability preferences in its guidelines on the suitability assessment to be updated by Q4 2018.”*

In addition, the Commission invited EIOPA and ESMA to provide final technical advice, including cost-benefit analysis, by 30 April 2019 on the integration of environmental, social

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union (COM(2015)468 final).

[5] The estimate is a yearly average investment gap for the period 2021 to 2030, based on PRIMES model projections used by the European Commission in the Impact Assessment of the Proposal of the Energy Efficiency Directive (2016).

[6] ‘Financing a sustainable European economy’ Final Report 2018by the High Level Expert Group on Sustainable Finance, 31.01.2018.

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

[8] OJ L 173, 12.6.2014, p. 349.

[9] OJ L 26, 2.2.2016, p. 19.

and governance considerations and preferences in the investment decision and advisory processes.

MiFID II became applicable on 3 January 2018 and, together with Regulation (EU) No 600/20142 (MiFIR), replaced Directive 2004/39/EC[10]. MiFID II and MiFIR provide for an updated harmonised legal framework governing the requirements applicable to investment firms, regulated markets, data reporting services providers and third country firms providing investment services or activities in the Union.

MiFID II and MiFIR aim to enhance the efficiency, resilience and integrity of financial markets.

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 environmental, social and governance (ESG) preferences, are usually not addressed. Existing suitability assessments generally do not include questions on ESG preferences of clients, while the majority of the clients would not raise the ESG issue themselves. As a result, investment firms consistently do not give appropriate consideration to ESG factors in the selection process.

This Regulation aims at clarifying that ESG considerations and preferences should be taken into account in the investment and advisory process as part of the duties towards clients.

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

2. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

The High-Level Expert Group on Sustainable Finance (HLEG) was set up in December 2016 to help develop an EU strategy on Sustainable Finance through recommendations: it published a HLEG interim report on "Financing a Sustainable European Economy" in mid-July 2017 and presented the report at a stakeholder event on 18 July 2017, followed by a consultation questionnaire. A feedback statement was published along with the HLEG final report on Financing a Sustainable European Economy on 31 January 2018. The feedback statement 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*".

In March 2018, the Commission sent a targeted questionnaire on the integration of environmental, social and governance considerations in the suitability assessment. The

[10] OJ L 145, 30.4.2004, p. 1.

consultation showed that only a minority of the clients proactively raise ESG issues during the advisory process. Some of the reasons for this are: i) the available information on ESG products is not transparent; ii) the risk of 'greenwashing' in existing documentation is high; and iii) there is a lack of education on the impact of ESG factors on risk and performance. Only in rare cases, clients seem to systematically raise ESG issues during the advisory process.

The Commission also organised a High-level conference on 'Financing sustainable growth' on 22 March 2018 to keep up the momentum with the One Planet Summit and continue to consolidate the support and commitment from EU leaders and key private players for the changes needed in the financial system to fund the transition towards a low-carbon economy.

In addition, the draft Delegated Regulation 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. Shareholders from different backgrounds (e.g. NGOs, financial industry associations, public bodies)[11] commented on diverse aspects of the proposed Delegated Act. 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 Finance Agenda but is also of the view that the newly introduced reference to the Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (Disclosure Regulation)[12] proposed timeline for the application of this delegated act (12 months after entry into force) provides for sufficient flexibility.

Some stakeholders also commented on the definitions: while some stakeholders were of the view that the definitions suggested within Art. 2 of this delegated act were too vague, others asked for broader definitions. The Commission addressed this issue by referring to the definition foreseen in the legislative proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341.[13]

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 ESG preferences on the other hand. This differentiation is important in order to avoid mis-selling, which may happen should an ESG consideration take precedence over a client's personal investment objective. Another recital shall then clarify that the ESG preferences should only be addressed within the suitability process after the identification of the client’s investment objective.

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

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

12 https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en.

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As Article 4 of the legislative proposal for a Disclosure Regulation lays down that financial market participants (including IDD and MiFID firms providing investment advice and portfolio management) must include pre-contractual disclosure information on how they incorporate sustainability risks, the pre-contractual disclosure requirements in Articles 47 and 48 have been removed from this delegated regulation. This shall ensure a harmonised application of pre-contractual disclosure rules amongst financial market participants. However, at a later stage, the Commission could revise the Regulation (EU) 2017/565 accordingly.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

In order to take into account environmental, social and governance preferences of clients, when investment firms provide investment advice or portfolio management, the Commission proposes an amendment of Articles 2, 52 and 54 in the Delegated Act supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms.

Article 1 of this Regulation aims at clarifying that investment firms providing financial advice and portfolio management should carry out a mandatory assessment of ESG preferences of their clients in a questionnaire addressed to them. These investment firms should then take these ESG preferences into account in the selection process of the financial products that are offered to these clients.

In addition, Article 1 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 ESG preferences (ex-post information disclosure).

Finally, Article 2 of this Regulation sets out the date of application of the proposed 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[14], and in particular Articles 24(13) and 25(8) thereof,

Whereas:

(1) Decision No 1386/2013/EU of the European Parliament and of the Council[15], established the Seventh Environment Action Programme. With a view to achieving that programme's objective to turn the Union into a resource-efficient, green and competitive low-carbon economy, that Decision called for stimulating consumer demand for environmentally sustainable products and services through policies which promote their availability, affordability, functionality and attractiveness.

(2) Directive 2014/65/EU established an obligation for investment firms to act in accordance with the best interests of their clients. As part of that obligation, Commission Delegated Regulation (EU) 2017/565[16] sets out that information on investment objectives should include information about the length of time for which a client or potential client wishes to hold an investment, his or her preferences regarding risk taking, his or her risk profile, and the purposes of the investment.

(3) On 8 March 2018, the Commission published its Action Plan 'Financing Sustainable Growth'[17], 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.

(4) There is a divergence in how investment firms that provide investment advice and portfolio management integrate Environmental, Social and Governance (ESG) considerations and preferences in their suitability assessments, which leads to

[14] OJ L 173, 12.6.2014, p. 349.

[15] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013D1386.

[16] 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)

[17] COM(2018) 97 final.

uncertainties and confusion for investors. To improve the functioning of the internal market and to stimulate the investor's demand for ESG products, the way those investment firms integrate ESG considerations and preferences into the suitability assessment should be harmonised.

(5) To enable investment firms that provide investment advice and portfolio management to recommend suitable products to their clients, those investment firms should introduce in their suitability assessment questions that help identify the client's individual ESG preferences. In accordance with their obligation to act in the best interests of the client, recommendations to clients should reflect both the financial objectives and, where relevant, the ESG preferences expressed by those clients.

(6) In order to avoid 'mismatches', investment firms providing investment advice should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences

(7) Investment firms should also explain to their clients how their ESG preferences for each financial instrument are taken into consideration in the selection process used by those firms to recommend financial products.

(8) For existing clients, for whom a suitability assessment has already been undertaken, investment firms should be able to rely on the existing suitability assessment.

(9) The provisions in this Regulation are closely linked since they deal with investment advice. To ensure coherence between those provisions, which should enter into force at the same time, and to ensure easy access to them, it is desirable to include those provisions in a single regulation.

(10) To enable investment firms to adapt to the new requirements contained in this Regulation, its application should be deferred.

(11) Delegated Regulation (EU) 2017/565 should therefore be amended accordingly,

HAS ADOPTED THIS REGULATION:

Article 1

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

(1) in Article 2, the following points are added:

"(7) 'ESG preferences' means a client's or potential client's choice as to whether and which environmentally sustainable investments, social investments or good governance investments should be integrated into his or her investment strategy;

(8) 'ESG considerations' means any factor associated with environmentally sustainable investments, social investments or good governance investments, or a combination of those factors;

(9) 'environmentally sustainable investment' means an investment as defined in Article 2 (o) (i) of Regulation XXX of the European Parliament and of the Council*;

(10) 'social investment' means an investment as defined in Article 2 (o) (ii) of the Regulation XXX of the European Parliament and of the Council;

(11) ‘good governance investment’ means an investment as defined in Article 2 (o) (iii) of the Regulation XXX of the European Parliament and of the Council.

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* Regulation (EU) XXXX/20XX of the European Parliament and of the Council of XXX on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (OJ…).”;

(2) 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 and, where relevant, ESG considerations.”;

(3) 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, the client’s risk tolerance and any preferences, including ESG preferences, where relevant;”;

(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 profile, the purpose of the investment and his or her ESG 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 ESG considerations 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:

“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 and his or her capacity to sustain losses and whether the client's investment objectives are achieved by taking into account his or her ESG preferences expressed.”.

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 [*12 months after the date of entry into force*].

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President
Jean-Claude JUNCKER