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EUROPEAN
COMMISSION

Brussels, XXX
[…](2020) XXX draft

COMMISSION DELEGATED DIRECTIVE (EU) .../…

of XXX

amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations

(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 Directive 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 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 Directive (EU) 2017/593 supplements Directive 2014/65/EU (MiFID II) by further specifying, among other things, product governance obligations. This Directive modifies Commission Delegated Directive (EU) 2017/593 in two ways:

Under the existing MiFID II framework, an investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients. The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.[3] Further, Article 24(2) MiFID II requires investment firms which manufacture financial instruments for sale to clients to ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market. Chapter III of the Delegated Directive (EU) 2017/593[4] lays down further details on the product oversight and governance process for both manufactures and distributors.

The conditions to identify a target market in Commission Delegated Directive 2017/593 adopted under Articles 16(12) and 24(13) of MiFID II did not yet explicitly establish the details of the integration of sustainability preferences by investment firms manufacturing financial instruments and their distributors. This Directive clarifies that sustainability preferences should be taken into account in the product oversight and governance process.

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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 See Article 16 para. 3 MiFID II, but also Art. 9 para. 3 MiFID II.

4 Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits

This Directive and other sectoral delegated acts that adapt rules on fiduciary duties and that were adopted alongside also reinforce the **Regulation on sustainability-related disclosures in the financial services**[5]**, the Regulation on the EU Climate Transition Benchmarks and the EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks**[6] and **the Regulation on the EU taxonomy for sustainable activities**[7]. 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 Directive is based on the empowerment set out in Articles 16(3) and 24(13) 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.

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.

In its mandate, the Commission highlighted that changes to the definition of the target market shall not lead to miss-selling practices, e.g. by clearly identifying investment objectives and sustainability constraints. In addition, the Commission reaffirmed that the possibility to identify a target market for clients without sustainability preferences should be maintained.

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5 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 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).

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

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 product governance and oversight structures prepared and publicly consulted by ESMA were integrated into this Delegated Directive.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

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

This Directive covers the following amendments to Directive (EU) 2017/593:

Article 1 aims at clarifying that manufacturers duly consider sustainability preferences when specifying the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible with. Further, the target market assessment in consideration of the respective product's risk/reward profile and product features should also cover the instrument's objective of sustainable investments or environmental or social characteristics . In the context of this review, manufacturers should also explicitly take clients' sustainability preferences into account.

Article 2 echoes these requirements for the distributors.

Finally, Article 3 sets out the date of application of the proposed Regulation, including the transitional period of 12 months.

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amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations

(Text with EEA relevance)

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[8], and in particular Article 16(12) and Article 24(13) 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[9]. Article 2(1), point (c), of the Paris Agreement sets out the objective of strengthening the response to climate change by, among others means, 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[10] 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’[11], 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.

(4) Proper implementation of the Action plan encourages investors’ demand for sustainable products. It is therefore necessary to clarify that sustainability factors and

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8 OJ L 173, 12.6.2014, p. 349.

9 Council Decision (EU) 2016/1841 of 5 October 2016 on the conclusion, on behalf of the European Union, of the Paris Agreement adopted under the United Nations Framework Convention on Climate Change (OJ L 282, 19.10.2016, p. 4).

10 COM(2019) 640 final.

11 COM(2018) 97 final.

preferences should be considered within the product governance requirements set out in Commission Delegated Directive (EU) 2017/593[12].

(5) Investment firms manufacturing and distributing financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile. Considering that the target market should be defined at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. It should rather be specified by the investment firms manufacturing and distributing financial instruments to which group of clients with specific sustainability preferences the financial instrument is supposed to be distributed.

(6) Delegated Directive (EU) 2017/593 should therefore be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1
Amendments to Delegated Directive (EU) 2017/593

Delegated Directive (EU) 2017/593 is amended as follows:

(1) in Article 1, the following paragraphs 5 and 6 are added:

"5. '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:
  (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;

6. sustainability factors' means sustainability factors as defined in Article 2, point (24), 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) Article 9 is amended as follows:

(a) in paragraph 9, the first subparagraph is replaced by the following:

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12 Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (OJ L 87, 31.3.2017, p. 500).

"9. Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, including any sustainability preferences, the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.";

(b) paragraph 11 is replaced by the following:

"11. Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:

(a) the financial instrument's risk/reward profile is consistent with the target market;

(b) the financial instrument's sustainability factors are consistent with the target market;

(c) the financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable.";

(c) paragraph 14 is replaced by the following:

"14. Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives, including any sustainability preferences, of the target market and if it is distributed to the target market, or reaches clients for whose needs, characteristics and objectives the financial instrument is not compatible."

(3) Article 10 is amended as follows:

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

"2. Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, including any sustainability preferences, of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, investment firms shall identify any group of clients for whose needs, characteristics and objectives the product or service is not compatible.";

(b) paragraph 5 is replaced by the following:

"5. Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives**,** including any sustainability preferences, of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.”.

Article 2
Transposition

(1) Member States shall adopt and publish, by [***OJ: please insert date - exactly twelve months minus one day after entry into force of this delegated act***] at the latest, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall forthwith communicate to the Commission the text of those provisions.

They shall apply those provisions from [***OJ: please insert date exactly 12 months after entry into force of this delegated act***].

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

(2) Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 3
Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 4
Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the Commission
The President
Ursula von der Leyen