BETTER FINANCE Feedback on obligations for investment firms to advise clients on social and environmental aspects of financial products

Introduction and aim of the amended delegated regulation

Commission Delegated Regulation (EU) 2017/565 supplements Directive 2014/65/EU (MiFID II) by further specifying organisational requirements and operating conditions for investment firms.[1]

This proposed amendment 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. [2]

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.*[4]

BETTER FINANCE's proposal for amendments

BETTER FINANCE welcomes the introduction of requirements for firms providing investment advice and portfolio management to ask clients about their non non-financial objectives and preferences. This is an important step forward for the integration of sustainability in the fiduciary

[1] file:///C:/Users/User/Downloads/090166e5d01e44aa%20(4).pdf
[2] Ibid.
[3] Final report on integrating sustainability risks and factors in the MIFID II (ESMA35-43-1737).
[4] file:///C:/Users/User/Downloads/090166e5d01e44aa%20(4).pdf

duties of financial advisers. However, we recommend some specific amendments in order to avoid:

- greenwashing practices in the "advice" and sale of sustainable financial products,
- misinterpretations of sustainability factors of investments,
- and non-intelligible questions to savers, which is not allowed by MIFID II (requirement of clear and understandable information)

According to recital *(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****."*[5]

We agree with the duty for investment firms to first address investment objectives, time horizon and individual circumstances of the client, before asking their potential sustainability preferences. However, sustainability preferences should not be seen as secondary information on the fiduciary of the investment firms. Therefore, questions on sustainability preferences should not be a mere *tick-the-box* assessment. The sustainability assessment should be consistent with the expectations expressed by individual investors and should not, in any case, be used for greenwashing, or to mislead individual investors. In order to be consistent with individual investors' expectations the questions related to sustainability preferences should be addressed in plain language and clearly aim at assessing the impact the client intends to pursue with its investment. In particular, if the investment advisor, after asking questions on non-financial preferences to the client, would propose simple negative screening products leading the investor to think that the proposed product would have a positive ESG impact in the real economy, it would be strongly misleading.

In this regard, the recital (5) should be amended as it follows:, *(5) […]* ***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 including the potential impact that the client intends to pursue with its investment.***

In addition, we want to underline that our proposed amendment is in line with the *HLEG final report on Financing a Sustainable European Economy on 31 January 2018* as it 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*".[6]

[5] file:///C:/Users/User/Downloads/090166e5d01e44aa%20(3).pdf
[6] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

Also, the definitions of what are "sustainable investments" and what are financial instruments that consider *"principal adverse impacts on sustainability factors"* are not intelligible for the average EU saver. Therefore, they are not compliant with the basic investor information rules of MIFID II which require that information be clear and understandable for the average client.

They will also require a very thorough training in ESG matters for investment "advisors" which will take time.

Therefore, we believe that the reference and a clearer definition of sustainable impact preferences is essential when referring to questions addressed to individual clients regarding their non-financial objectives, thus preventing any of form mis-selling and greenwashing products. A simpler definition, more likely to be understood both by the "advisor" (if we can use this word for a person that is compensated with sales commission) and the client is proposed below.

The text below reports the amended regulation including BETTER FINANCE's amendments in red.

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 impact preferences' means a client's or potential client's choice in regards to the potential impact intended to be pursued with its investment as to whether the following financial instrument 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;* [7]

(8) 'sustainability factors' means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088; [8]

[7] Article 2 (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council; "***sustainable investment'*** *means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance"*

[8] *"(24) 'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."*

(9) 'sustainability risks' means sustainability risks as defined in Article 2, point (22), of Regulation (EU) 2019/2088.[9]

(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;*

[9] *"(22) 'sustainability risk' means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment;"*

(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."

(d) the firm or that person does not follow the requirements established in Article 2, paragraph 7 against the interest of the client, resulting in miss-selling practices and greenwashing as defined in Recital (9) of the taxonomy regulation.[10]

(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 and the sustainable impact intended to be pursued by the client";

(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 impact 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 including the potential sustainable impact intended to be pursued, if any.";

(c) paragraph 9 is replaced by the following:

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[10] REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the establishment of a framework to facilitate sustainable investment : "*(9) the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards". Additionally, the entity-level disclosures of principal adverse impacts of investment decisions on sustainability factors could give rise to greenwashing at financial market participant level."*

“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.”;