Consultation Response

The European Commission's draft delegated acts (amending Delegated Directive (EU) 2017/593 to integrate sustainability factors and preference 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)

6 July 2020

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.

Implementation timeline for the draft Delegated Directive on product governance

We note that the Commission's proposed sequencing for Member States to implement the draft Delegated Directive on product governance could pose significant challenges for firms, and we therefore recommend an appropriately staggered implementation timeline (please see the product governance section below and the schematic in the Appendix). We also note that availability of relevant and reliable ESG data from issuers remains a significant issue (and will continue to remain so for some time), which will impede the process of identifying to what extent a product meets a client's sustainability preferences (please see the second paragraph of our response[1] to the Commission's consultation on the revision on the EU Non-Financial Reporting Directive (NFRD) for our views on the availability of ESG data).

To the extent further changes to the product governance rules under MiFID II are contemplated either in the 2020 COVID-19 securities markets response package or in the context of the wider MiFID II review, we believe that there should be alignment of the two sets of changes to ensure firms are clear on the cumulative effect and not required to undertake two sets of assessments and changes in rapid succession.

MiFID II financial instruments without environmental and/or sustainability factors

We note that, because MiFID II's definition of a financial instrument[2] is broader than the definition of a financial product under both Regulation (EU) 2020/852 (the Taxonomy Regulation)[3] and Regulation (EU) 2019/2088 (the Disclosure Regulation),[4] there are some MiFID II financial instruments that will not have environmental and/or sustainable factors. We therefore believe that firms' assessment of environmental, social and governance (ESG) features should be limited to products that are manufactured with a specific sustainable investment objective or ESG characteristics, as it would be inappropriate and disproportionate to require investment firms to assess ESG characteristics of non-ESG financial instruments.

Definition of sustainability preferences in Article 1(5) of the draft Delegated Directive on product governance and Article 2(7) of the draft Delegated Regulation on suitability

We are still reviewing the definition of sustainability preferences in Article 1(5) of the draft Delegated Directive and Article 2(7) of the draft Delegated Regulation, particularly with respect to how Article 8 and 9 of the

[1] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf
[2] See Article 4(15) of MiFID II, available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02014L0065-20160701&from=EN
[3] See Article 2(3) of the Taxonomy Regulation, available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN
[4] See Article 2(12) of the Disclosure Regulation, available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN

Disclosure Regulation should be applied to financial instruments. We would appreciate the opportunity to engage further with the Commission on this issue.

<u>Comments on draft Delegated Directive (EU) 2017/593 (product governance)</u>

The draft Delegated Directive on product governance requires Member States to adopt and publish the law reflecting the Delegated Directive into domestic legislation "exactly ***twelve months minus one day*** after entry into force of this delegated act [the Directive] at the latest" (Note: The Directive would enter into force on the 20th day following its publication in the Official Journal of the European Union). The law itself ***would be required to apply*** within Member States exactly ***12 months after entry into force of the Directive***. This implementation timeline is very short and, in extreme cases, could leave firms with only one day between the publication of the law into domestic legislation and its entry into force.

We recommend that Member States' domestic legislation reflecting the Delegated Directive should enter into force ***9 months*** after the deadline for Member States to transpose it into domestic legislation. This will let firms upgrade their IT systems, integrate clients' sustainability preferences, and redesign their product governance processes (including necessary exchanges between manufacturers and distributors). In the lead-up to MiFID II, it generally took industry 9 months to agree solutions between manufacturers and distributors.

The draft Delegated Directive should be amended so that, as recommended by ESMA, investment firms integrate clients' ESG preferences into their product governance processes "**where relevant**".[5] This would allow firms to disapply the Delegated Directive's sustainability requirements to financial products that do not have sustainability elements (e.g. foreign exchange and interest rate derivatives) and to scenarios where clients do not have sustainability preferences. We do not think that a negative target market should be identified with regard to ESG preferences in the "objectives and needs" section of the target market assessment. We believe that guidance on how to apply the updated product governance requirements would be helpful for manufacturers of financial instruments that are not "financial products" as defined in Article 2 of the Disclosure Regulation.

We must note that retail investors generally have legitimate investment needs which may be in addition to their ESG considerations (e.g. portfolio diversification and/or solutions to hedge risks). It is therefore essential that manufacturers can create products that meet such investors' needs, even when the product is unrelated to ESG. In order to avoid limiting the availability of such products to investors who have expressed ESG preferences, we would reiterate that, as stated in the preceding paragraph, it should be clarified that the negative target market does not apply to ESG considerations. This would be in line with the Commission's approach to suitability, which tends to clarify that ESG considerations are preferences that complement an investor's other expressed investment objectives.

In practice, an investment service provider should identify the relevant investment universe according to the usual suitability test criteria. On the basis of the investment range selected, the investment service provider checks whether proposing ESG products is relevant, taking into account the needs expressed by the investor. By way of example, for a retail investor that seeks to invest only in long term solutions with a preferred tax treatment (e.g. retirement saving plans), the expression of an ESG preference by such investor should not lead to an unfavourable arbitrage between the two sets of specifications. The investor should be confident that the ESG preference will not conflict with his/her previously expressed preferences which may be unrelated to ESG.

Manufacturers should not be required to conduct periodic reviews (which incorporate ESG considerations) of financial instruments that have been issued before the coming into force of the updated Delegated Directive and for which the original target market assessments do not include sustainability preferences. Because our recommendation may cause uncertainty among distributors who may not receive post-review feedback containing information about whether investors with ESG preferences are in the positive, negative, or grey target

[5] See pages 20 and 21 of ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II, available here: https://www.esma.europa.eu/sites/default/files/library/esma35-43-1737_final_report_on_integrating_sustainability_risks_and_factors_in_the_mifid_ii.pdf

market, we believe that distributors would benefit from guidance clarifying that, in such cases, they should classify such investors as being in the grey potential target market. We note that manufacturers should have flexibility to conduct reviews of products that are marketed after the entry into force of the Delegated Directive during their next regular review of target markets. As a general point, retrospective application of the draft Delegated Directive to secondary fixed income markets risks triggering market sell-offs which could be destabilising.

The proposed changes will require firms to make procedural and operational changes to several existing processes across different business areas. Manufacturers will need to factor the changes in to their distribution strategies to receive feedback on the target market from distributors. Firms' business, compliance and risk functions will need to change their periodic review processes, where appropriate, to identify any failures with compliance and include relevant sustainability information in their reports to senior management.

Comments on draft Delegated Regulation EU 2017/565 (suitability, firms' organisational requirements and operating conditions)

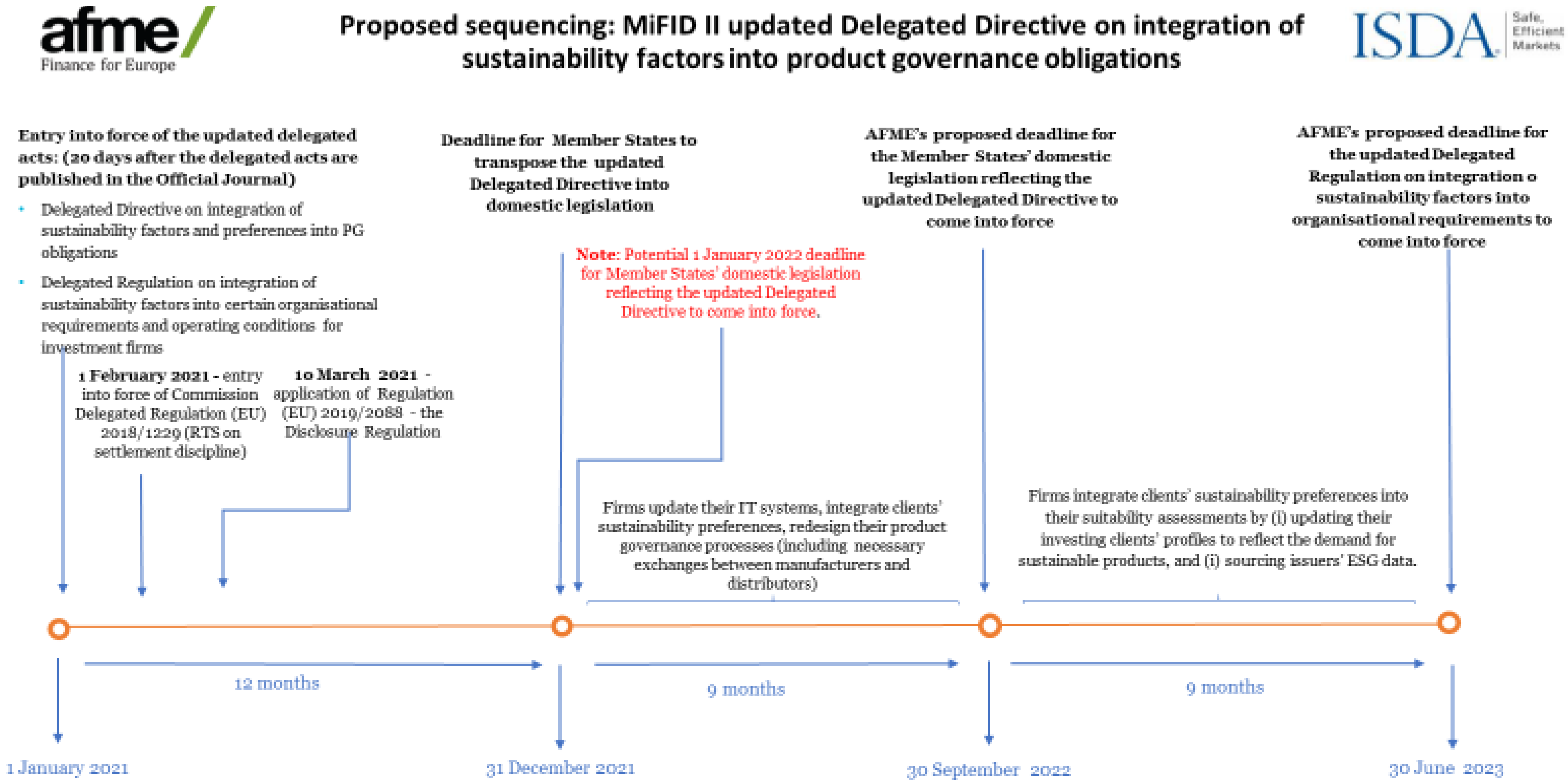
Firms will need enough time to integrate clients' sustainability preferences into their suitability assessments by (i) updating their investing clients' profiles to reflect the demand for sustainable products and (ii) sourcing issuers' ESG data. We note that availability of relevant and reliable ESG data from issuers remains a significant issue (and will continue to remain so for some time), which will impede the process of identifying to what extent a product meets a client's sustainability preferences (please see the second paragraph of our response[6] to the Commission's consultation on the revision on the EU Non-Financial Reporting Directive (NFRD) for our views on the availability of ESG data).

We therefore believe that the Commission's proposed Delegated Regulation on firms' organisational requirements and operating conditions should apply ***nine months*** after the deadline for the national laws reflecting the updated Delegated Directive on product governance to take effect.

Firms would also require an appropriately staggered timetable for implementing the above delegated acts due to other regulatory changes that are scheduled to take place in 2021 and the significant IT and systems updates associated with such changes. These include the entry into force on 1 February 2021 of Commission Delegated Regulation (EU) 2018/1229 (RTS on settlement discipline) and application from 10 March 2021 of Regulation (EU) 2019/2088 (the Disclosure Regulation).

[6] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ISDA%20NFRD%20revision%20consultation%20response_Final_11062020.pdf

Appendix


afme/
Finance for Europe
Proposed sequencing: MiFID II updated Delegated Directive on integration of sustainability factors into product governance obligations
ISDA
Safe, Efficient Markets
Entry into force of the updated delegated acts: (20 days after the delegated acts are published in the Official Journal)
Delegated Directive on integration of sustainability factors and preferences into PG obligations
Delegated Regulation on integration of sustainability factors into certain organisational requirements and operating conditions for investment firms
1 February 2021 - entry into force of Commission Delegated Regulation (EU) 2018/1229 (RTS on settlement discipline)
10 March 2021 - application of Regulation (EU) 2019/2088 - the Disclosure Regulation
Deadline for Member States to transpose the updated Delegated Directive into domestic legislation
Note: Potential 1 January 2022 deadline for Member States' domestic legislation reflecting the updated Delegated Directive to come into force.
Firms update their IT systems, integrate clients' sustainability preferences, redesign their product governance processes (including necessary exchanges between manufacturers and distributors)
AFME's proposed deadline for the Member States' domestic legislation reflecting the updated Delegated Directive to come into force
Firms integrate clients' sustainability preferences into their suitability assessments by (i) updating their investing clients' profiles to reflect the demand for sustainable products, and (i) sourcing issuers' ESG data.
AFME's proposed deadline for the updated Delegated Regulation on integration o sustainability factors into organisational requirements to come into force
12 months
9 months
9 months
1 January 2021
31 December 2021
30 September 2022
30 June 2023

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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.