EUROPEAN
COMMISSION

Brussels, XXX
[…](2018) XXX draft

COMMISSION DELEGATED REGULATION (EU) …/...

of XXX

amending Regulation (EU) 2017/565 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

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 proposed on [23 May 2018] 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**

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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:

Plan for Europe[3], the **Circular Economy Package**, the **Energy Union package**, the **Capital 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 will 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.

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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).

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.

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). Based on this information, investment firms assess which products are suitable for the client. The existing regime sets out which information must be obtained from the client as part of the 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 consideration in the selection process.

This Regulation aims at clarifying that ESG considerations 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*".

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

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 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.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

In order to take into account environmental, social and governance investment objectives of clients, when investment firms provide investment advice or portfolio management, the Commission proposes an amendment of Articles 47, 48, 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 and defined terms for the purposes of that Directive.

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.

Article 1 also seeks to improve the information regarding the ESG factors of financial products that is given to the clients before the provision of investment advice and portfolio management services (ex-ante information disclosure).

Finally, 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).

Article 2 of this Regulation sets out the date of application of the proposed Regulation, including the transitional period of 18 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[11], and in particular Articles 24(13) and 25(8) thereof,

Whereas:

(1) On 25 September 2015, the UN General Assembly adopted a new global sustainable development framework: the 2030 Agenda for Sustainable Development[12] having at its core the Sustainable Development Goals (SDGs). The Commission's Communication of 2016 on the next steps for a sustainable European future[13] links the SDGs to the Union policy framework to ensure that all Union actions and policy initiatives, within the Union and globally, take the SDGs on board at the outset. The European Council conclusions of 20 June 2017 confirmed the commitment of the Union and the Member States to the implementation of the 2030 Agenda for Sustainable Development in a full, coherent, comprehensive, integrated and effective manner and in close cooperation with partners and other stakeholders.

(2) In 2016 the Union concluded the Paris Climate Agreement[14]. Article 2(c) of the Agreement sets the objective to strengthen the response to climate change, among other means by making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

(3) Sustainability and the transition to a low-carbon and climate resilient, more resource-efficient and circular economy are key in ensuring long-term competitiveness of the Union's economy. Sustainability has long been at the heart of the European Union project and the Unions Treaties give recognition to its social and environmental dimensions.

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

[12] 'Transforming our world: the 2030 Agenda for Sustainable Development' Resolution adopted by the General Assembly on 25.9.2015.

[13] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions: Next steps for a sustainable European Future. European action for sustainability (COM(2016) 390 final).

[14] OJ L 282, 19.10.2016, p. 4–18.

(4) On 8 March 2018, the Commission published its Action Plan 'Financing Sustainable Growth'[15] 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.

(5) Decision No. 1386/2013/EU of the European Parliament and of the Council[16] called for an increase in private sector funding for environmental and climate-related expenditure, notably through putting in place incentives and methodologies that encourage companies to measure the environmental costs of their business and profits derived from using environmental service.

(6) Directive 2014/65/EU establishes an obligation for investment firms to act in accordance with the best interests of their clients. As part of that obligation, investment firms providing investment advice and portfolio management are required to obtain information regarding the client's or potential client's knowledge of and experience in the investment field, and his or her financial situation and investment objectives, including his or her risk tolerance. Delegated Regulation (EU) 2017/565[17] sets out that information on investment objectives should include information about the length of time, for which a client wishes to hold an investment, his or her preferences regarding risk taking, his or her risk profile, and the purposes of the investment.

(7) To better identify the client's investment objectives, it should be clarified what consideration investment firms should give to Environmental, Social and Governance (ESG) preferences in the investment and advisory process.

(8) There is a divergence in how investment firms providing investment advice and portfolio management integrate ESG considerations in their suitability assessments, which leads to uncertainties and confusion for investors. To improve the functioning of the internal market, the way those investment firms integrate ESG considerations into the suitability assessment should be harmonised.

(9) To enable those investment firms to recommend the most suitable products to the client, investment firms providing investment advice and portfolio management should introduce questions in their suitability assessment that would help identify the client's investment objectives, including ESG preferences. The final recommendations to the client should reflect both the financial objectives and, where relevant, the ESG preferences of that client. Investment firms providing investment advice and portfolio management should consider each client's individual ESG preferences on a case-by-case basis. Investment firms should offer those financial products that correspond to

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15 COM(2018) 97 final.

16 Decision No. 1386/2013/EU of the European Parliament and of the Council of 20 November 2013 on a General Union Environment Action Programme to 2020 'Living well, within the limits of our planet' (OJ L 354/171 28.12.2013).

17 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)

the ESG preferences of the client, in accordance with their obligation to act in the best interests of the client.

(10) To enable clients to make well-informed investment decisions, investment firms should disclose, where relevant, information on the ESG preferences of each financial product offered to clients before providing investment services.

(11) Investment firms providing portfolio managemnt should provide the client with information about the types of financial instrument that may be included in the client protfolio and types of transaction that may be carried out in such instruments. As part of this obligation, investment firms should also explain how client’s ESG preferences are taken into account in the process of selecting financial instruments for client’s portfolio.

(12) Investment firms should also explain to the client how his or her ESG preferences for each financial instrument is taken into consideration in the selection process used by those firms to recommend financial products.

(13) To allow investment firms to adapt to the new requirements contained in this Regulation so that they can be applied in an efficient and effective manner, this Regulation should apply 18 months after the date of its entry into force.

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

HAS ADOPTED THIS REGULATION:

Article 1

Amendments to Delegated Regulation (EU) 2017/565

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

1. In Article 2, points (7), (8) and (9) are added:

(7) ‘ESG preferences’ means a client’s or potential client’s preferences for environmentally sustainable investments, social investments or good governance investments;

(8) ‘ESG considerations’ means a consideration related to environmentally sustainable investments, social investments or good governance investments’;

(9)‘environmentally sustainable investment’ means an investment in an economic activity that contributes to an environmental objective, and in particular an environmentally sustainable investment as defined in Article 2 of [insert reference to taxonomy Regulation]

(10) ‘social investment’ means an investment in an economic activity that contributes substantially to a social objective, and in particular an investment that contributes to tackling inequality, an investment fostering social cohesion, social integration and labour relations, and an investment in human capital or economically or socially disadvantaged communities;

(11) ‘good governance investment’ means an investment in companies following good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance.”;

2. In Article 47(3), point (d) is replaced by the following:

"(d) the types of financial instrument that may be included in the client portfolio, based on the client's investment objectives, including any ESG preferences, and the types of transaction that may be carried out in financial instruments, including any limits;."

3. In Article 48(1), the first sentence is replaced by the following:

"Investment firms shall provide clients or potential clients in good time before the provision of investment services or ancillary services to clients or potential clients with a general description of the nature and risks of financial instruments, taking into account in particular any ESG considerations and the client's categorisation as either a retail client, a professional client or eligible counterparty."

4. 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, such as risks, costs and complexity of the financial instruments or, where relevant, ESG considerations."

5. 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 preferences, including environmental, social and governance considerations";

(b) paragraph 5 is replaced by the following:

"5. The information regarding the investment objectives of the client or potential client shall include, where relevant, information on the length of time for which the client wishes to hold the investment, his or her ESG preferences, if any, his or her preferences regarding risk taking, his risk profile, and the purposes of the investment".

(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 environmental, social and governance considerations, 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."

(b) paragraph 12 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 objectives, including ESG preferences, if any, and personal circumstances with reference to the investment term required, the client's knowledge and experience, and client's attitude to risk and capacity for loss."

Article 2

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

2. This Regulation shall apply [insert date: 18 months after the date of entry into force].

3. 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