



Brussels, 3 July 2020
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EACB Feedback
on
Draft delegated acts on Sustainable Finance
obligation to advise clients on social and
environmental aspects:
MiFID II, UCITS Directive, AIFMD, and IDD

July 2020

The **European Association of Co-operative Banks** ([EACB](http://www.eacb.coop)) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4,050 locally operating banks and 58,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 210 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 79 million members and 749,000 employees and have a total average market share of about 20%.

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Introduction

The EACB welcomes the opportunity to provide its feedback on the draft delegated acts to MiFID II, UCITS Directive, AIFMD, and IDD stemming from the goals of the European Commission's 'Action Plan: Financing Sustainable Growth' to (i) integrate sustainability within investment advice (Action 4); and (ii) clarify the integration of sustainability in so-called fiduciary duties (Action 7).

Our members as co-operative banks mainly provide investment advice for and portfolio management in financial products within the scope of MiFID II, and thus, are particularly focused on the distributors' obligations to the client and the relationship with the product manufacturer in this regard. However, we also see it relevant to provide our comments on the delegated acts of the other directives so as to ensure a harmonised approach in line with the Better Regulation Agenda.

The key messages we wish to convey are that:

- **SFDR and Taxonomy should lead the way in terms of sustainable finance:** In no way should such Level II amendments under the various sectoral legislation over-ride the basis for sustainable finance already established under the published Regulation (EU) 2019/2088 ("SFDR") and Regulation (EU) 2020/852 ("Taxonomy Regulation"), in particular relating to terminologies (**e.g. definition of sustainability preferences and distinction between Article 8 and 9 SFDR products**). The only instances where the consideration of sectoral legislation is explicitly stated with respect to directives, regulations, delegated acts and regulatory technical standards, is within the "financial impact" of sustainability risks (recital 14 SFDR) and their integration in remuneration policies (Article 5 SFDR), marketing communications (Article 13 SFDR), supervision by NCAs (Article 14 SFDR) and the document in which pre-contractual disclosures and periodic reporting can be made (Article 6(3) and Article 11(2) SFDR and Article 7 Taxonomy). The risk of maintaining these inconsistencies or over-riding the SFDR and Taxonomy is that the different sets of obligations could create complexity for the client and the business. Transparency only works in terms of investor protection if the client is not overloaded with information and is able to understand the disclosures presented in a simple manner;
- **Alignment with MiFID II/ MiFIR review:** The Commission would also do well to consider the proposals made by all stakeholders during the consultation period on the review of MiFID II/ MiFIR conducted in Q1-12 2020, particularly with respect to product governance provisions and the suitability assessment. For example, the obligations between financial and sustainability characteristics, objectives and preferences should be cohesively implemented – failure to do so would mean repeating systems and documentation updates which is time consuming, costly and confusing for both investors and financial entities. Therefore, any proposals from the MiFID II/ MiFIR review which are eventually adopted should also be mirrored in the context of sustainable finance with the exception of the concept of the negative target market; and

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- **Timing:** We also believe that for the same reasons stated above, it is only fair to ask for alignment with respect to timing of implementation of the draft delegated acts with the upcoming regulatory amendments under the holistic review of MiFID II and MiFIR. Implementation deadlines of the draft delegated acts should also be aligned with the SFRD, Taxonomy, NFRD and Climate Benchmarks Regulation.

Our further detailed comments can be found in the following sections.

MiFID II (Product Governance)

This section relates to the draft amendments to Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations.

Based on the proposed draft amendments, both manufacturers and distributors have to consider sustainability preferences in their processes and in target market considerations. This raises some questions from our members that should be addressed before approving the final draft:

Scope of application:

- 1. Limitation of scope by product type:** In [reply](#) to the Commission's consultation paper on the 'Review of the regulatory framework for investment firms and market operators' dated 17 February 2020, the EACB called for simplification of the product governance rules: *"...we would recommend to exempt all "non-complex" as well as in practice "simple" products from target market requirements, as long this is not raising any concern in terms of competitiveness between similar products from an economical perspective and complexity but belonging to different asset classes. In this context, the EACB proposes that a more cohesive, material definition of such a "simple investment product" is clarified, which may allow for certain instruments to be included in the definition. Furthermore, proportionality should be applied as this is not being done as expected...the product governance requirements should only apply to transactions with retail clients as regarding professional clients and eligible counterparties there is no risk of misspelling."* We also extend this position for the consideration of ESG factors and preferences when establishing the target market; and
- 2. Clarification in Article 10(2) draft Delegated Directive (distribution):** With regard to Article 10(2) of the draft Delegated Directive, it should be clarified that the sustainability preferences are only relevant in the case of investment advice and not in the case of orders without advice. This would help achieve a parallelism with the appropriateness and suitability test, and reflects the SFDR only puts financial market participants and financial advisors in scope insofar as the provision of investment advice or portfolio management.. In our reply to the Commission's consultation on the review of MiFID II, we also take into account the fact that product governance requirements should not apply for "execution-only" services. Therefore, it should be made clear in the draft directive that execution-only services are not in scope of the draft directive. We are also in favour of clarifying that

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sustainability is not subject to deviation reporting and therefore no information to the manufacturer is required in the case of target market deviations, i.e. negative target markets should not be considered with regard to "sustainability preferences". The present draft does not contain any statement on these two aspects.

Definition of sustainability preferences:

- 1. Alignment of the definition of sustainability preferences with the draft regulation to amend Delegated Regulation (EU) 2017/565:** The definitions of sustainability preferences are not completely identical in the draft regulation and the draft directive. The version from the draft regulation is preferable, as the products can then be better labelled (product under Article 2(7)(a) draft Delegated Regulation); and
- 2. Alignment of the definition of sustainability preferences with the SFDR and Taxonomy:** Under the SFDR, three product categories are identified: Article 9 products, Article 8 products and non-Article 8 or 9 products. This categorization is also reflected in the Taxonomy, and the products have come to be known as 'Dark Green', 'Light Green' and 'Mainstream' respectively. Therefore, the understanding has become that Article 8 products are those integrating ESG-ratings when investing across (almost) all industries. This would cover approaches like best-in-class or integration. The aim of these products is (almost) exclusively to generate a financial return. On the contrary, Article 9 products focus on an environmental or social impact. Generating a financial return could be considered in this case a by-product not the main feature. Article 1(5) No. 5 of the draft Delegated Directive provides for an extension of the definition of sustainability preferences by further criteria beyond Article 8 SFDR. This would lead to considerable contradictions between the MiFID II Delegated Directive, the SFDR and the Taxonomy, which must not occur. De facto, a new product category would be created for reasons we do not understand. In view of this, points (i) and (ii) Article 1(5) No. 5 of the draft Delegated Directive should be deleted, and this should solely refer to Article 8 SFDR products. In the same vein, reference should be directly made to Article 9 SFDR products in lieu of the following section: "*...a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17) of Regulation (EU) 2019/2088*". The reason for this is because Article 2(17) SFDR makes reference to a "sustainable investment" which raises concerns in terms of scope with "Dark Green" products. It is better to make a link to products as per Article 9 SFDR rather than sustainable investments.

Data:

Product distributors should be able to use ESG target market parameters on all the financial instruments in scope. This would mean that they should be able to receive the ESG target market information from each product manufacturer. However, it is highly likely that distributors will not receive nor have themselves in hand all the target market ESG parameter data once this delegated directive comes into place. This should be taken into consideration during the first years of implementation. Furthermore, this concern of target market information not being available

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from the offeror/issuer of investment products has even been brought up by ESMA in their final report of 19 December 2014 (ESMA/2014/1569) which states that "Going forward ESMA considers that the EC should consider the possibility to align the relevant UCITS and AIFMD articles with the product governance obligations for manufacturers". We extend this consideration also to ESG factors in terms of target market information in the UCITS Directive and AIFMD. This obligation from the manufacturer should also be clarified in the Prospectus Regulation.

Granularity vs Homogeneity:

Recital 5 of the draft directive states that: "Considering that the target market should be defined at a sufficiently 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". Our concern with this statement is due to the difficulty in applying granularity at this stage. It is easier according to our members to apply a single indicator and communicate such information to clients in a simple and meaningful way. The independent specification of environmental, social and governance considerations is a complex topic for all parties: clients, distributors and product manufacturers. This process would also require a granular set of rules to deal with clashing sustainability preferences of clients. There is also increased risk that some investment products may be skewed to a certain topic in such situation. For this reason, we would advocate to remove such recital from the draft directive.

Clarification on offering of mainstream products:

One of the questions that has been raised by our members is whether one can offer mainstream products to clients with Article 8 and 9 SFDR sustainability preferences. Since the publication of SFDR and Taxonomy, it has become more common to categorise clients based on three categories: Article 9 SFDR products (whereby sustainability preferences would be mandatory), Article 8 SFDR products (whereby there is a preference for sustainability) and mainstream products (whereby there is indifference to sustainability preferences). It is understood that for clients that fall under the Article 8 and 9 categories, mainstream products could be offered in situations where there is no suitable or alternative sustainable product but the financial suitability criteria is a match with the client. Although this is what is understood in practice, it would be good to provide clarification in the legal draft in this regard.

Timing:

- 1. Implementation vs. transposition:** According to Article 2 (1) of the draft directive, Member States should have 12 months after publication in the EU Official Journal to implement the draft directive. At the same time, national transposition should take place no later than 364 days after publication of the text in the Official Journal of the EU. This would mean that, in extreme cases, banks would only know the national regulations one

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day before they have to apply them. This will simply be impossible. It is imperative that a reasonable implementation period be provided;

- 2. Alignment with the SFDR:** Furthermore, this directive is likely to be published in the Official Journal of the EU during Q4 2020 with application date around Q4 2021 considering the 12-month implementation period. We wonder how this will work in practice since SFDR will become applicable as from 10 March 2021; and
- 3. Alignment with other workstreams:** There should also be consideration of consistency between the implementation deadlines of the delegated act with other upcoming MiFID II amendments, and sustainable finance workstreams such as the NFRD, the Taxonomy and the Climate Benchmarks Regulation. At the very least, a sufficient grace period should be allowed for implementation of these product governance amendments.

MiFID II (Suitability assessment and Organisational Requirements)

This section relates to the draft amendments to Delegated Regulation (EU) 2017/593 as regards the integration of sustainability factors and preferences into the suitability assessment and organisational requirements of MiFID II.

Scope of application:

- 1. Exemption by financial instrument for particular purposes:** As derivatives (OTC/ETD) / hedging transactions / forward transactions are regularly used to hedge business risks and sustainability considerations are not relevant to them, these products should be excluded from the scope of the draft regulation.
- 2. No grandfathering:** It is noted that the following statement is made on page 3 of the 'Explanatory Memorandum' preceding the draft regulation: "*To enhance legal certainty, the references to sustainable investments were specified and the recitals were amended: it was clarified that a new suitability assessment for existing contracts will generally not be necessary*". However, this clarification on non-applicability to existing contracts is not specified in the draft regulation and we would ask that the relevant wording is incorporated in the legal text.

Definition of sustainability preferences

We echo a similar issue as above-mentioned in the product governance amendments, but this time as per under Article 2(7)(b) of the draft Delegated Regulation which provides for an extension of the definition of sustainability preferences by further criteria beyond Article 8 SFDR. This would lead to considerable contradictions between the MiFID II Delegated Regulation, the SFDR and the Taxonomy, which must not occur. De facto, a new product category would be created for reasons we do not understand. In view of this, points (i) and (ii) in Article 2(7)(b) of the draft Delegated

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Regulation should be deleted, and this should solely refer to Article 8 SFDR products. In the same vein, reference should be directly made to Article 9 SFDR products in lieu of Article 2(7)(a):

"...a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17) of Regulation (EU) 2019/2088". The reason for this is because Article 2(17) SFDR makes reference to a "sustainable investment" which raises concerns in terms of scope with "Dark Green" products. It is better to make a link to products as per Article 9 SFDR rather than sustainable investments.

Suitability assessment:

In recital (5) of the draft regulation, it is mentioned that: "...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." Based on this wording it seems that the investment advisor must first ask the clients about their investment objectives, time horizon and individual circumstances, followed by an assessment of ESG preferences. It could thus be interpreted that the ESG factors and preferences would be considered in the investment decision process only after ascertaining the client's investment objectives etc.. Whilst our members will always ensure to factor in ESG factors and preferences in their investment advice (and portfolio management), we think that the process to assess both clients' investment objectives etc. and sustainability criteria should be left to the investment firm to decide, provided that the sustainability criteria do not override financial suitability ones.

We are thus firmly of the opinion that the questioning of the client about their potential sustainability preferences and the assessment of other client information like the client's investment objectives etc. can also be carried out in a one-step process. There is no mandatory need for a two-step-process. For this reason, we advocate to delete this last sentence in recital 5 of the draft regulation.

Taking the previous comment into account, we would suggest the following wording for 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 assess both the investor's financial criteria (investment objectives, time horizon and individual circumstances) and also the investor's sustainability preferences. The process to assess both financial and sustainability

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preferences of the investor should be determined individually by each investment firm, provided the latter preferences do not override the former. The above also applies for the wording under recital 6 of the draft regulation.

Furthermore, where there are no suitable ESG products when other requirements are fulfilled, the draft directive does not disclose how to handle these kind of situations. According to the text: *"Further, it 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 sustainability preferences (ex-post information disclosure)."* We are not sure if it is reasonable on this basis to recommend to the client a product based only financial preferences followed by a statement in the investment advice report (ex-post) that *"this investment advice meets the other objectives but does not meet the client's ESG preferences"*.

Taking this view into account, we would suggest the following wording in Article 54, paragraph 12, first subparagraph:

"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, their personal circumstances with reference to the investment term required, the client's knowledge and experience, the client's attitude to risk, their capacity to sustain losses and -where enough information is available regarding the sustainability characteristics of the existing range of products- their sustainability preferences".

Alignment with SFDR:

According to recital (6): "Investment firms that provide investment advice and portfolio management services should clearly explain the distinction between financial products that promote environmental or social characteristics and financial products that pursue sustainable investment objectives. That is why the identification of the client's sustainability preferences should in case of financial products that promote (Article 8) environmental or social characteristics take into account those financial products that at least to some extent pursue sustainable investment objectives (Article 9), or consider principal adverse impacts on sustainability factors, as laid down by Regulation (EU) 2019/2088." This is something that product manufacturers must define but is also an obligation for distributors. However, we do not understand what the underlined sentence means in practice but we assume it is proposing an extended category of Article 8 products which we do not support as explained in our sections on "Definition of sustainability preferences". Unless this recital could be clarified, we would strongly advise to delete the above section from the recital.

Timing:

- 1. Alignment with SFDR:** The regulation is likely to be published in the Official Journal of the EU during Q4 2020 with application date around Q4 2021 considering the 12-month

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implementation period. We wonder how this will work in practice since SFDR will become applicable as from 10 March 2021; and

- 2. Alignment with other workstreams:** There should also be consideration of consistency between the implementation deadlines of the delegated act with other upcoming MiFID II amendments, and sustainable finance workstreams such as the NFRD, the Taxonomy and the Climate Benchmarks Regulation. At the very least, a sufficient grace period should be allowed for implementation of these product governance amendments.

UCITS Directive

This section relates to the proposed Delegated Directive amending Directive (EU) 2010/43/EU (UCITS Directive) as regards the integration of sustainability factors and preferences organisational requirements, conflicts of interest, risk management and due diligence requirements of mutual funds.

Alignment with SFDR:

Regarding consideration of principal adverse impacts on sustainability factors, it is our understanding that Article 7(1) SFDR allows to differentiate on a product level (i.e. "a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors").

Therefore, we think that with respect to the addition of Article 23(6) via Article 1(5) of the draft directive, reference should rather be made to Article 7(1)(a) SFDR (instead of Article 4(1)(a) SFDR (which applies at entity level but not at level of a particular product).

Timing:

Furthermore, the timing issue once again arises between the timetables of the draft directive application and the SFDR. In particular, the Level II text of the SFRD is also running late in terms of publication and one wonders if there will be a harmonised or phased approach in implementation of both these Level II texts in this regard.

AIFMD

This section relates to the proposed amendments to the Delegated Regulation (EU) No 231/2013 as regards the integration of sustainability factors and preferences in organisational requirements, conflicts of interest, risk management and due diligence requirements of alternative investment fund managers.

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Alignment with SFDR:

Regarding consideration of principal adverse impacts on sustainability factors, it is our understanding that Article 7(1) of the SFDR allows to differentiate on a product level (i.e. “a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors”).

Therefore, we think that with respect to the addition of Article 18(6) via Article 1(2) of the draft regulation, reference should rather be made to Article 7(1)(a) SFDR instead of Article 4(1)(a) SFDR (which applies at entity level but not at level of a particular product).

Timing:

As a regulation the obligations here could be applied without transposition or implementation, but we think that in reality there should be consistency with the UCITS obligations. Therefore, the same issues in timing for the section on the UCITS Directive should also be taken into account.

IDD

This section relates to the proposed amendments to Delegated Regulation (EU) 2017/2358 and Delegated Regulation (EU) 2017/2359 as regards the integration of sustainability factors and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.

We would just like to highlight in this section that we are against revisiting any past investment advice given with respect to those insurance contracts/insurance products that were sold prior to the draft regulation entering into force. This would be complex to apply retrospectively and thus we ask for clarification in the draft regulation that the amendments would only apply for new insurance contracts and products.

Contact:

The EACB trusts that its comments will be taken into account.

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