

EFAMA's comments on ESMA's consultation paper on integrating sustainability risks and factors in MiFID II

GENERAL REMARKS

EFAMA¹ agrees with ESMA's suggestions to integrate sustainability risks within the MiFID II requirements through high-level principles. They allow for a proportionate consideration of ESG factors and risks by investment firms at a time when the sustainable investment market is rapidly developing, and discussions on the wider regulatory framework are not yet finalised (e.g. taxonomy). Given that a common understanding of relevant sustainability factors and risks has not yet crystallised, regulators will need to take a more flexible approach in order not to overburden market participants, investors and capital-seeking enterprises.

The new requirements must therefore be flexible enough to ensure that the full scope of sustainable investment approaches can still be carried out – dependent on the investor's particular objectives. The proposed flexible approach will allow all market participants to progress from different starting points while at the same time avoiding overly burdensome implementation costs. This approach should also allow enough leeway for compatibility with future sustainability discussions outside the EU which, in turn, should boost global efforts to jointly tackle today's challenges.

We believe ESMA's understanding of 'sustainability risk' to be a good starting point in the UCITS/AIFMD consultation² as it links it to the financial materiality of an investment. Sustainability risk must be understood as the financial impact on the investment arising from environmental, social and governance considerations. This is different to the process of integrating ESG factors in the investment decision-making process, a concept linked to sustainable investment. These considerations should also be kept in mind for changes to MiFID II, whose ultimate purpose is to ensure that investors understand the impact of ESG risks on their investments and are able to take decisions on the basis of that knowledge.

It is essential for ESMA, but also EIOPA and the Commission, to ensure consistency in all concepts and definitions not only within their internal respective work streams (i.e. MiFID II and UCITS/AIFMD) but

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 14.1 trillion managed by 58,400 investment funds at end 2016. Just over 30,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 27,800 funds composed of AIFs (Alternative Investment Funds). www.efama.org

² Page 7, para. 17 of ESMA's Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD states that "In light of the above and for the purposes of the delegated acts pursuant to the UCITS Directive and AIFMD, 'sustainability risk' could therefore be understood as the risk of fluctuation in the value of positions in the fund's portfolio due to ESG factors." ([link](#))

also on a cross-sectoral basis (e.g. consistency of those two legislations with Solvency 2 and IDD). Most importantly, consistency can be further improved by aligning the terminologies used. 'ESG' and 'sustainability' are being used interchangeably throughout this and ESMA's other consultation on the AIFM and UCITS Directives without any clear definitions of either. It is therefore essential for ESMA (and EIOPA) to align their final advices to the Commission accordingly.

Last but not least, it is essential that sufficient time be allowed to implement these changes. The Commission is suggesting only twelve months which is far too little time taking into account that changes to the MiFID II Delegated Directive must be implemented into Member States' national laws first, followed by changes to the current target market concept. This will take time.

ANSWERS TO QUESTIONS

Section 2: Organisational requirements

1. Do you agree with the suggested approach and the changes to the Article 21 of the MiFID II Delegated Regulation on 'general organisational requirements'? Please state the reasons for your answer.

We agree with the high-level, principled based approach and the changes to the Article 21 of the MiFID II Delegated Regulation. They acknowledge that ESG considerations may impact different areas of an investment firm, allowing for an overarching integration into the investment firm's organisational requirements.

We would welcome further clarifications as to how ESMA envisages this approach having an impact on an investment firm's human resource. That being said, it should be up to firms to decide how they ensure their staff have the appropriate skills and expertise.

Ultimately, it will be key to ensure that the revised organisational requirements tie in with other legislative requirements currently under negotiation.

2. Do you agree with the suggested approach and the changes to the Article 23 of the MiFID II Delegated Regulation on 'risk management'? Please state the reasons for your answer.

We support a proportionate approach given the fast development of the market and the need for integration across firms' risk management. However, we believe that further clarifications are needed.

First, it should be made clearer whether ESG factors always have to be considered by the investment firms or only in instances where ESG considerations are relevant for the provision of the investment services provided to particular clients. EFAMA understands the proposals to mean the former, which is in line with the prospect of the EC Action Plan and ESMA's proposed changes to the UCITS and AIFM framework as currently being consulted. However, if ESMA's intention – along the lines of Article 21 – is the latter, then we would suggest the clarifications below.

Second, the consideration of ESG factors requires the availability of ESG data, which remains at an early stage, but with strong potential for improvement.

We suggest clarifications to Article 23 of the MiFID II Delegated Regulation:

Investment firms shall take the following actions relating to risk management:

(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~~ **Where ESG considerations are relevant for the provision of investment services to clients and proportionate to the availability of appropriate and relevant data, investment firms shall take into account environmental, social and governance factors. [...]**

It is important, though, that flexibility in assessing sustainability risks is maintained, while markets providing sustainable finance mature. This is of particular importance as the nature of these long-term risks means that typical risk management techniques may not prove adequate for these purposes.

This is also of particular relevance due to the data required to make these assessments. Currently available data is imperfect at best. We suggest that ESMA – in line with its high level principles-based approach – should ensure that investors do not find themselves dependent on third-party imperfect data to fulfil some of the requirements, in particular around risk management in practice.

3. Do you agree with the suggested approach and the new recital on 'conflicts of interest'? Please state the reasons for your answer. What would be specific examples of conflicts of interests that might arise in relation to sustainability considerations?

We agree that ESG considerations should not lead to mis-selling practices, but conflicts of interest requirements may not be the best way to address this issue. From a practical point of view, the advisory and product governance process are better placed for this purpose, in particular by addressing the understanding that the product has to be, where relevant, compatible with the client's needs and objectives and, in the case of investment advice, also suitable. With that in mind, we believe that no specific recital is necessary.

However, if ESMA insists on a recital to include sustainability considerations, a short reference to ESG considerations in the existing Recital 59 should be sufficient. This would ensure that ESG conflicts of interest do not take precedence over other conflict of interest issues, but are rather integrated horizontally as any other risk into the advisory process. Our suggested amendment to Recital 59 of the MiFID II Delegated Regulation is:

"The placing process involves the exercise of judgement by an investment firm as to the allocation of an issue, and is based on the particular facts and circumstances of the arrangements, which raises conflicts of interest concerns, **including those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments.** The firm should have in place effective organisational requirements to ensure that allocations made as part of the placing process do not result in the firm's interest

being placed ahead of the interests of the issuer client, or the interests of one investment client over those of another investment client. In particular, firms should clearly set out the process for developing allocation recommendations in an allocation policy.

4. Do you think that on the topic of 'organisational requirements' other amendments should be made to the MiFID II Delegated Regulation in order to incorporate sustainability risks and factors? If yes, which ones? Please state the reasons for your answer.

No other amendments to the MiFID II Delegated Regulation regarding organisational requirement are required. The proposed high-level principle-based approach is appropriate given the fast development of the market and the need to integrate ESG considerations holistically as other investment risks.

Section 3: Product governance

5. Which existing market standards or "labels" are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.

From a European perspective, we note the existence of a multitude of national market standards or labels on top of the more recent considerations regarding an "EU Ecolabel for Financial Products"³. In September 2016, EFAMA published the latest iteration of its "report on responsible investment"⁴. Annex 3 of that report contains a comprehensive overview regarding the existing private sector initiatives in different Member States that in existence at the time of publication.

We acknowledge these efforts. However, it must be noted that the sheer number of different initiatives highlights the current divergences in approaches, considerations and outcomes. In essence, they are meant for domestic markets and are impossible to compare with each other. We therefore also cannot see how such labels/standards can be used in a meaningful manner in a cross-border scenario.

With regards to ESMA's suggestion to categorise ESG preferences according to Taxonomy proposal (para. 8 on page 14), we do not believe that approach is practical as it may not be in line with investors' expectations. For instance, investors usually do not distinguish between climate mitigation and climate adaptation or between waste prevention and a healthy ecosystem. Most of them are, in fact keen, to invest in either ESG or SRI products but have no particular preferences between different aspects of ESG. We therefore believe that this approach is too complex and would probably overburden investors.

In addition, the Taxonomy proposal is still under discussion, meaning that the final delineations are still uncertain. To implement such preliminary considerations, followed by an adjustment later on, would further confuse investors and require the market to adjust recently implemented systems.

³ EU Ecolabel for Financial Products: 1st Stakeholder Questionnaire on the product scope and criteria definition: [Link](#)

⁴ EFAMA report on Responsible Investment, September 2016: [link](#)

Neither of these outcomes would facilitate a positive approach towards sustainability which is vital in order to achieve the urgently needed progress.

Furthermore, we doubt that the Taxonomy, once completed, will allow specification of ESG preferences. The Taxonomy focuses only on economic activities and is therefore on a different level to ESG preferences applicable to financial instruments covering solely such activities such as green bonds. For the majority of financial instruments, the Taxonomy alone will not allow retail investors to identify environmentally sustainable investments and is currently overlooking other invaluable investment strategies, such as company engagement.

6. Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Directive Articles on 'product governance'? If not, please explain.

We generally agree with ESMA's assessment of the importance of the target market concept being at the heart of the information exchange between product manufacturers and distributors. In practice, the industry will attempt to integrate these new requirements into the existing European MiFID Template (EMT). This is a machine-readable template that assists the matching of manufacturers' products to distributor clients' needs, which is used throughout Europe by MiFID stakeholders⁵.

With this in mind, we see that the suggestions could have a significant impact on the current version of this pan-European template, in particular in relation to the fields needed to describe a theoretical ESG target market. Whatever changes are required, it is important to consider that these template revisions will need to be agreed by all stakeholders and then integrated into their IT systems. This will take time.

Paragraph 9, conversely, implies that a meaningful level of granularity must be more than a flag to indicate that a product is "ESG", as ESMA suggests that E, S and G must be specified separately (i.e. at least separate 'multiple-choice' flags). We do not agree with this assessment as it would make the suitability process for such products incredibly complex. This does not reflect the majority of sustainable funds (or how ESG factors may be integrated in the holistic investment research process) which usually cover all three aspects. It also contradicts Question 9 which suggests that ESG could be considered as a single criterion.

7. Do you agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements and the addition of an additional case study? If not, please explain what changes should be made and why.

We agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements. Given the interlinkages with the Delegated Regulation, please also consider our answer to Question 6 above.

With regards to paragraphs 12 and 13 we strongly support ESMA's suggestion that ESG criteria do not have a negative target market.

⁵ <http://www.efama.org/Documents/20171115-EMT%20V1.0%20QA.xlsx>

However, the case study put forward is unrealistic, as it describes a product being invested into primarily illiquid assets but which still provides both daily pricing and daily liquidity. In practice, such a product would not have a low risk indicator. Furthermore, it is unclear what the "green project" certificate would be based on. Lastly, the fund cannot be a UCITS since unlisted assets are not eligible UCITS assets, but the specific reference to the UCITS KIID implies otherwise. We therefore do not believe that this specific case study will be helpful and suggest it is deleted.

8. Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.

We value ESMA's confirmation that ESG considerations should not be relevant as a factor of a negative target market. That being said, we do not see a need for additional guidance.

9. Please specify any approach you see to identify environmental, social and governance criteria separately from each other or as a single indicator. Please explain how the criteria would interact with each other and how the target market assessment and matching would be performed in such cases.

In responding to this question we consider the practical consequences of implementing the new requirements into the current procedures the industry has developed to meet the MiFID target market requirements. Not all distributors sell their own manufactured products. Independent product manufacturers could be at a competitive disadvantage if the requirements of the specific target market are drawn to narrowly.

We therefore recommend, as a first step, to view ESG criteria as a single indicator (i.e. E, S and G should *not* be considered separately), as this reflects the majority of currently available products in the market and the current expectations of investors. On a practical level, it may be the case that individual product manufacturers or distributors chose to implement individual criteria for E, S or G. In such a scenario, it is essential that these can be matched with a 'single ESG indicator' assessments. In this example, it should mean that a product is "ESG" compatible if at least one of the three criteria (E, S or G) is met.

Furthermore, all ESG aspects interact with each other. For instance, we suggest that a company with poor governance is more likely not to comply with international labour standards or harm the environment than a company with good governance. Even if clients have a preference for social or environmental aspects, for example, they would also fall into the target market of products addressing both aspects.

Section 4: Suitability

10. What current market standards or “labels” are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or “labels”? Please describe.

The concepts of product governance and suitability are intricately linked in the MiFID II framework. Please therefore consider our comments to Question 5 on the existing national labels and market standards that also apply to suitability considerations.

11. Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines? If not, do you have any suggestions for developing a more detailed approach with regard to (a) the collection of information from clients and (b) the assessment of ESG preferences with the assessment of suitability?

We do not agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines. In line with our response to Question 5 and 6, the classification system is not the right basis for collecting information on clients and we do not believe that a simple distinction can be made between environmental, social or governance factors. Furthermore, the approaches differ depending on the individual client. For instance, professional clients are more likely to have clear expectations towards the ESG characteristics of a product.

ESMA's existing guidelines already state that it is good practice for firms to collect information on the client's preferences on ESG factors. Therefore, firms are currently developing the best approach to collect this information based on clients' approaches to sustainability. ESMA's proposed amendments may not be in line with clients' approaches. We would therefore ask ESMA to refrain from too detailed wording in order to allow for much needed flexibility. In addition, a revised paragraph 28 should also be more explicit on the very real possibility that a client may not have any ESG preferences.

That being said, we welcome the Commission's clarifications in the draft amendments to the Delegated Regulation⁶ (Recital 6) in relation to suitability and clients' ESG preferences, which state that “investment firms providing investment advice should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences.”

With this in mind, we believe that the proposed new paragraph 28 of the suitability guidelines go beyond the Commission's intentions, as it implies that the upcoming EU taxonomy (or any future EU label) will be a binding requirement for the purpose of the suitability assessment. To realign the Level-3 guidelines with the revised Level-2 requirements, we suggest paragraph 28 to be rephrased as follows:

⁶ Link: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf

When collecting information about their clients' ESG preferences, ~~firms should ask questions in relation to environmental, social and governance factors. The information collected on clients' ESG preferences~~ should be granular enough to allow the firm to assess the suitability of the investment, ~~and should be consistent with the EU's classification system of ESG investment products, once developed. While this classification system is under development, investment firms should clearly specify what they consider to be ESG preferences or considerations, while taking into account current market standards.~~ Investment firms should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences. Within the suitability assessment process, investment firms should allow for the necessary differentiation between investment objectives on the one hand and ESG preferences on the other hand. This differentiation is important in order to avoid mis-selling, which may happen should an ESG consideration take precedence over a client's personal investment objective. Firms should bear in mind that for products produced by financial participants (as opposed to, for example, individual stocks and shares), EU law requires integration of ESG factors in the general investment management process and information disclosure on how this is taken into account is available in product documentation

We note the proposed phrase "other criteria that are relevant for the assessment of suitability" in para 12 on page 23. This highlights the need for a flexible approach as suggested by ESMA. However, ESMA suggests two approaches, "simplified" and "advanced". Unfortunately, the latter is based on metrics measuring sustainability that are still under development and thus do not provide sufficient standardisation to use this data confidently for the time being. With this in mind, we assume that for the foreseeable future the simplified approach will rather be the most advanced approach for the time being.

12. Please specify any approach you see to assess environmental, social and governance criteria separately from each other or as single preferences. Please explain how the criteria would interact with each other and how the suitability assessment would be performed in such cases.

Please also note our detailed response to Questions 5, 6 and 9. ESG criteria are not mutually exclusive. They are highly interlinked. Clients' demands may be too sophisticated to be met by a silo-assessment of E, S and G. It is therefore essential – in line with our previous comments – to start initially with a single ESG indicator.

13. Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

Yes, however it should be clarified that the reference to existing clients in paragraph 17 of the consultation paper should be read in the context of ongoing monitoring of the relationship with the client and not as requiring a re-assessment of all clients regardless of the contract. In this respect, we refer to the Commission's clarification in the draft MiFID Delegated Act which clarified that a new suitability assessment for existing contracts will generally not be necessary (see Recital 8).

14. What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk-management arrangements, market researches and analyses, organisational costs, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

No comment.

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