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INVESTMENT ASSOCIATION RESPONSE TO ESMA CONSULTATION PAPER: ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MIFID II

ABOUT THE INVESTMENT ASSOCIATION

- The IA represents 250+ UK-based investment management firms who collectively manage funds totalling EUR 8.1 trillion; of which EUR 2 trillion is on behalf of European clients. The UK asset management industry is a key part of both the UK and EU's financial ecosystem, helping millions of individuals save for the long-term and enabling them to enjoy a more prosperous retirement.
- Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.
- Our purpose is to ensure investment managers are in the best possible position to:
 - Build people's resilience to financial adversity
 - Help people achieve their financial aspirations
 - Enable people to maintain a decent standard of living as they grow older
 - Contribute to economic growth through the efficient allocation of capital.
- The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs (a form of tax-incentivised savings account in the UK).

1. OVERARCHING COMMENTS

The Role of Asset Managers in Sustainability

As asset managers and significant investors in economies across Europe, it is our role to help investors and savers achieve their objectives – both financial and non-financial.

Whilst responsible investment has existed in various forms for many years, as an industry we are witnessing growing demand for sustainability-related and responsible investment strategies, as investors have become much more aware of the material impact sustainability issues (both environmental and social) could have on financial returns and on broader economic and financial stability. This trend has helped fuel the growth in the responsible investment market and our members are committed to continuing to promote and develop sustainability and responsible investment in all of its forms.

The IA has therefore welcomed the Commission's Sustainable Finance Package with its broad objectives to 1) reorient capital flows towards sustainable investments, 2) manage financial risks stemming from ESG issues; and 3) foster transparency and long-termism in financial and economic activity.

As this is a comprehensive and far-reaching Package, it is vital that the scope of each of the individual Proposals as well as any subsequent components, including this consultation paper, is clarified and that these components harmoniously with each other to progress this broad agenda.

We ask that European policy makers also consider the global implications of the Package. A lack of coordination, including at a global level, could have unintended consequences which may risk putting a brake on existing economic activities that already contribute to a more sustainable economy, as well as on further innovation and growth.

The IA supports European policy makers' commitment to make Europe a global leader in sustainable finance and stands ready to work with ESMA and other key stakeholders to progress this agenda and boost the role of finance in achieving both a well-performing economy and one that also delivers on environmental and social goals.

We thank ESMA for this opportunity to provide feedback on the proposed technical advice to the European Commission on the integration of sustainability risks and factors in MiFID II, in relation to:

- Organisational requirements
- Risk management
- Product governance; and

- Suitability

We were also grateful for the opportunity to hear from ESMA directly at the public hearing in Paris on 4 February 2019.

Support for a High-Level Principles-Based Approach

We strongly support the decision to take a high level principles-based approach to this task and would like to stress the importance of this.

We also support ESMA's commitment **not to pursue prescriptive measures** to ensure that this relatively young and fast-paced marketplace can continue to grow and innovate.

Investors should be able to continue to access **the full range of sustainability and responsible investment approaches** to meet their many and diverse objectives.

The Proposals in the Context of the European Commission Action Plan

We are keen to ensure that the constituent parts of the Sustainable Finance Package work together in harmony to ensure the original objectives of the European Commission's Action Plan of March 2018 are progressed.

As such, we appreciate ESMA's decision to address suitability assessments at this time to complement the work of the Commission in amending Delegated Acts under MiFID and IDD to include ESG considerations into financial advice and, more specifically, to deliver on the Commission's invitation to include provisions on sustainability preferences in ESMA's guidelines on suitability assessment.

We understand that the proposals set out in this CP are intended to progress both Actions 4 and 7 of the Action Plan ("incorporating sustainability when providing financial advice" and "clarifying institutional investors' and asset managers' duties" respectively). We also note that Action 4 is intended to take forward the Commission's aim to "reorient capital flows towards a more sustainable economy", whilst Action 7 is designed to "mainstream sustainability into risk management". As such, we recognise that these proposals seek to further two complementary objectives of the Commission's Action Plan and we would like to stress the distinction between these two aims.

There is a risk that these two separate focuses will be conflated in future policy work. We think it is critical in designing the appropriate regulatory interventions to distinguish between those interventions that have as their object the inclusion of sustainability considerations in investment processes (Action 7); and those which address products and mandate design (Action 4).

We hope that our feedback will help to ensure that, on the one hand, **clarifications to organisational requirements and risk management will help to embed sustainability into risk management** and, on the other, that **amendments to product governance and suitability assessment can help to capture and deliver on investors' sustainability preferences, if any, through the provision of investment advice and in the manufacture of financial products.**

ESG Preferences

We are supportive of measures to integrate ESG preferences in the provision of financial advice.

However, we have concerns around the possible unintended consequences of the proposed amendments from *how* such preferences would be captured and delivered on.

In particular, we have serious concerns around the proposed link between the MiFID Suitability Assessment and the European Commission's developing Taxonomy. We think ESMA's recommendation that firms should "rely on the categorisations that are being defined by the Commission in the taxonomy", when setting out ESG preferences that an investment products fulfils, is misplaced.

It is imperative that flexibility in the market is retained to draw on any one of a number of different and varied sustainability and responsible investment approaches, which cater to investors' multiple and varied investment objectives. Any automatic link between ESG preferences and the Taxonomy would significantly restrict the scope of "ESG preferences", deviating from current market standards and from being able to deliver on investors' varying sustainability objectives.

The Taxonomy may provide a useful tool for the identification of economic activities that are deemed to be environmentally sustainable but we have serious concerns around the scope of its application for investment purposes. By limiting the remit to specific environmentally sustainable economic activities, the Taxonomy only addresses a limited number of the many sustainability and responsible investment approaches. This kind of limited-scope tool may be useful in the context of impact or thematic investment approaches, as it can help to identify specific investment outcomes, but it cannot seek to replicate a holistic approach to sustainability and responsible investment.

It is worth noting that these investment approaches form only a very small part of the market – the IA's most recent Asset Management Survey found that only 0.02% of our members' assets under management (AUM) is allocated to impact investing strategies. There is significantly more interest in other sustainability and responsible investment strategies. For

example, assets in investment approaches which involve the exclusion of certain companies or sectors based on sustainability criteria account for 7% of AUM, some 350 times that invested in impact approaches, according to our most recent statistics.¹ However, the Taxonomy would not support this kind of sustainability-related investment approach.

We would therefore advocate removing any link between ESG preferences in product governance or suitability assessment to the Taxonomy. Above all, we want to avoid unintended consequences that would increase the risk of harming or mis-selling to consumers who express sustainability preferences.

ESG Considerations

We notice that ESMA has not provided a definition for “sustainability risk”. Whilst we understand the desire to wait for the outcomes of other aspects of the Sustainable Finance Package, we nonetheless feel that a non-binding, indicative definition needs to be adopted in these proposals to ensure that we have a shared understanding of how these proposed amendments would work in practice.

We are supportive of the direction set by the European Council in the Disclosure Proposal, linking “sustainability risk” to an “environmental, social or governance event or condition” that, if it occurs, could cause to a “material negative impact on the value of the investment”, and also support the link that ESMA has made to financial materiality in the CP integrating sustainability risks and factors in the UCITS Directive and AIFMD.

Above all, sustainability risks must be linked to financial materiality. Ideally, we would suggest the following definition for “sustainability risks”:

Any and all relevant environmental, social and governance considerations that may be deemed to have a negative and financially material impact on the long term sustainability of an investment²

¹ IA Asset Management Survey 2018. Investment approaches which embed sustainability through explicit exclusion of certain companies or sectors represented 7% of AUM. <https://www.theinvestmentassociation.org/assets/files/research/2018/20180913-fullsummary.pdf.pdf> (pp.30-1).

² “Investment” might refer to a company, but it could also refer to a number of different things in which you can invest. Examples include real assets (metals, real estate, land etc.) and governments (e.g. United States T-Bills).

1. ANSWERS TO SPECIFIC QUESTIONS

GENERAL ORGANISATIONAL REQUIREMENTS

Q1. Do you agree with 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 are supportive of a high level principles-based approach to the incorporation of ESG considerations within a firm's processes, systems and controls. We would agree it is important that staff involved in investment decision making or the advisory process possess the necessary skills, knowledge and expertise to consider all risks necessary to carry out their role in the best interests of the clients, including an assessment of sustainability risks, where financially material to an investment approach or investment decisions. As such, we are supportive of a proportionate approach such that sustainability risks are viewed alongside credit risk, market risk, and liquidity risk.

It should be up to firms to decide exactly how they ensure that their employees possess the necessary skills, knowledge and expertise. In particular, we would welcome clarification that such requirements do not necessarily involve recruiting an entirely separate and new team to fulfil these human resource expectations.

Furthermore, we would suggest including a reference to both sustainability "risks" and "factors" in the proposed amendments to general organisational requirements. ESG considerations can encompass both the mitigation of sustainability risks as well as benefiting from sustainability-related opportunities, or "factors" more generally. Please see suggested wording below:

IA suggested amendments to Article 21 (1) of MiFID Delegated Regulation:

Investment firms shall comply with the following organisational requirements:

[...]

When complying with the requirements set out in this paragraph, investment firms shall take into account the natures, scale and complexity of the business of the firms, **and** the nature and range of investment services and activities undertaken in the course of that business, **and the effect of sustainability risks and factors.**

RISK MANAGEMENT

Q2: 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 are supportive of the high-level principles-based approach taken to the incorporation of ESG factors in the risk management process. We would point out that the data available to firms on sustainability risks is still very limited and imperfect. A high level principles based approach should be maintained to ensure firms are not reliant on the services of unregulated data providers.

Having said this, it is important to consider that well-developed data and metrics would only ever form one part of the full picture of sustainability. Considering the sustainability of an investment involves more than counting the number of accidents in a company's factories year-on-year. It is also a qualitative assessment of the kinds of forward-planning a business puts in place to bolster, in this case for example, the safety and well-being and, consequently, the productivity and retention of its workforce. Any amendments to risk management must allow the flexibility for these wider qualitative considerations to be taken into account, to encourage and promote engagement by asset managers with companies on how sustainability considerations are reflected in a company's business strategy.

CONFLICTS OF INTEREST

Q3: 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 relations to sustainability considerations?

Of course, we want to avoid mis-selling scenarios. However, we do not consider it proportionate to consider conflicts of interest in relation to sustainability considerations separately from other considerations.

We would advocate no explicit reference to ESG considerations in the context of conflicts of interest. However, if ESMA feels strongly that it must be included in some way, we would ask that it is included within recital 59 as follows:

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.

Q4: 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, we do not suggest any further amendments.

PRODUCT GOVERNANCE

Q5: 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.

As asset managers, we might seek to apply a product label to our financial product, in particular, we might do this if a particular client has asked this of us. However, we would not apply a label to all investment strategies that take account of ESG factors. Moreover, different labels will reflect different sustainability-related investment approaches, for example, some may highlight exclusions whilst others may highlight a best-in-class approach. As labels reflect different approaches, they will not necessarily help to compare like-for-like. The most important thing is that any label conveys clarity of purpose as well as clarity on which aspects of sustainability it seeks to draw attention to.

In the course of 2018, the IA conducted an evaluation of existing labelling systems. From our observations, there appears to be little consistency between existing labels and, more importantly, little clarity around exactly what these labels are trying to draw attention to. What is more, it is expensive to apply a label to a product, in particular the verification process and – in many cases – it is not entirely clear what the benefit is.

Not only can existing labelling systems be unclear and costly, asset managers will often apply their ESG integration and stewardship policy at firm-level. So, the application of a label at product level is unlikely to give a full picture of a firm's sustainable investing practices.

In short, labels, as they are currently scoped, will not necessarily help investors find the products where ESG considerations have been taken into account most thoroughly and most effectively.

Future Industry Work on Labels

The IA has recently launched its own consultation with members on a possible product label for the retail market. We have scoped a proposal for a label with a number of key parameters, including target audience and status (mandatory versus voluntary). We are yet to receive and explore the results of this consultation but thought it might be helpful to share with you that we are undertaking this initiative in attempt to bring greater visibility and comparability to sustainable approaches.

Finally, we are also aware of a number of other efforts in different EU member states to develop national labels – it is important that any new EU label does not duplicate this existing work, as this would create confusion in the market. More specifically, as we explain above, we would caution against any overarching “sustainable finance” label that automatically linked to the Taxonomy alone, given its narrow scope.

MIFID II DELEGATED DIRECTIVE

Q6: Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Articles on ‘product governance’? If not, please explain.

We agree with ESMA’s assessment of the importance of target market as the focus of the exchange of information between product manufacturers and distributors.

Given the importance of this channel in ensuring ESG preferences are reflected into the manufacture and distribution of products, we would welcome clarification and further dialogue with ESMA on a number of key challenges. We outline these below:

In practice, a large part of building ESG preferences into the product governance will involve how these preferences are reflected in 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 all MiFID stakeholders.³ Significant changes will be necessary to ensure that the automated process of using the EMT is fit for purpose. Moreover, as we outline in our introductory comments above, any automatic link between ESG preferences and the Taxonomy must be removed.

Not only will the EMT require significant revisions, there are a number of other areas in which ESG preferences will need to be built in, in a meaningful and practicable way to ensure clients’ objectives can be acted upon.

Below we provide an illustrative, non-comprehensive, list of the kinds of documentation that will need revising:

³ <http://www.efama.org/Documents/20171115-EMT%20V1.0%20QA.xlsx>

- Prospectus
- KIID/KID
- Reports & accounts
- Distributor Template
- Financial Promotions
- Platforms would have to amend their suitability questionnaire/process and possibly have to provide extra information

Finally, we have some concerns around how manufacturers will obtain the relevant information from distributors (discussion on amendments to paragraph 14, covered in the last bullet of paragraph 7 on page 14).

Right now, there are also significant cost constraints in a low returns environment which bring additional challenges to this space. Namely, there are significant challenges to, on the one hand, streamline and automate processes to bring down costs, therefore, bringing investment services to more people than ever before and, on the other, to ensure that the wide range of ESG preferences can be delivered to investors.

Our goal in flagging these challenges is to illustrate the size and scale of the task which lies ahead for industry to ensure that ESG preferences are embedded into existing processes in such a way that investors' many and various ESG preferences may be captured in the manufacturer and distribution of products. Industry therefore needs sufficient time and flexibility to build in these changes in a meaningful way which works across product manufacturing and distribution and communicates clearly to the end consumer.

ESMA GUIDELINES

Q7: 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 any why.

We agree with ESMA's decision to not have a negative target market for ESG criteria.

We are supportive of having an additional case study but have some concerns around the case study given, namely, that it predominantly relates to illiquid assets and would not in practice have the low risk indicator suggested in the consultation.

Q8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, provide details.

We would not advocate further guidance on these points.

Q9: 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.

Sustainability and responsible investment approaches are many and varied to fit the many and varied investment objectives of investors.

In terms of current market developments, products are being developed with combined ESG characteristics and in these cases ESG should be used as a single indicator (ESG together). In a smaller number of cases, products might be designed to meet specific environmental (E), social (S) or governance (G) requirements only, and separate indicators should be available for these cases.

Above all, it is crucial that flexibility is maintained to facilitate the distribution of existing multiple and varied sustainability-related products as well as any future approaches to sustainability-related products and investment approaches.

SUITABILITY

Q10: what current market standards or “labels” are you intending to take into account or already taking into account for the considerations 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 which also apply to suitability considerations.

Q11: 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 (1) the collection of information from clients and (b) the assessment of ESG preferences with the assessment of suitability?

Whilst we strongly support the need to incorporate ESG preferences in the provision of investment advice, we have questions around how the proposed amendments would impact the suitability assessment process in practice.

- ESG preferences can refer to a whole range of approaches – how would this be captured in terms of questions asked? – Particularly given this process is practice automated?

- We will need significant levels of end-investor education in terms of what approaches are available
- The consultation paper states that sustainability considerations should not outweigh the relevance of the other suitability criteria in a way that might not result in the client's best interest. It also states that ESG preferences should only be addressed once the suitability has been assessed in accordance with the criteria of knowledge, experience and financial situation and investment objective, as a "second step". We are unsure how this would work in practice, given the nature of the EMT and the growing trend toward automated advice (which is serving to democratise financial services, providing advice to those who may not otherwise be able to afford it).
- Moreover, the suggested approach as it stands presents a legitimate dilemma for financial advisers if a client's ESG preferences do in fact come into conflict with or contradict their best interest, as ascertained during the standard "first step" suitability process involving the aforementioned criteria. In such a scenario, it is unclear how financial advisers should be expected to respond, or indeed whether they should then take account of a client's ESG considerations at all. This may pose additional practical challenges and confusion for fund managers and financial advisers in respect of their existing fiduciary duties to end-investors.
- How would the proposed amendments relate to labels? And what would be the unintended consequences for unlabelled products that nonetheless integrate sustainability considerations? In this context in particular, we would urge against taking a prescriptive and binary approach (ESG versus non-ESG).

Q12: 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 performances in such cases.

We refer you to our answer to Q9.

Q13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

Yes.

COST-BENEFIT ANALYSIS

Q14: 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.