Dear Sirs,

**PIMFA’s response to ESMA’s Consultation Paper - On integrating sustainability risks and factors in MiFID II**

We set out in the accompany appendix our response to the questions set out in the Consultation Paper (‘CP’).

The term ESG is used in various contexts throughout the CP but there is no information as to what is meant by the term ESG, which we highlight as being problematic in our responses to a number of questions. We note that the European Commission’s impact assessment (SWD (2018) 264) sets out in figure 1 a list of ESG factors. It may be helpful if the ESMA amendment to the legislation had a reference to this material. The content of the CP assumes there is a common understanding as to what ESG means which we do not believe reflects the current position amongst investment firms and certainly does not reflect the current position amongst clients and potential clients.

We believe MiFIDII regulation should be amended to include a definition of ESG preferences. We note that the draft Commission Delegated Regulations on sustainable finance states in Article 1 ‘ESG preferences’ means a client’s or potential client’s choice as to whether and which environmentally sustainable investments, social investments or good governance investments should be integrated into his or her investment strategy.
In our view there is a difference between taking account of a client’s ESG preferences and receiving a direct instruction from a client not to invest in certain companies or sectors. For example, a client may not wish to invest in a particular online company because of their tax strategy but the firm’s view may be that the online company’s tax strategy is acceptable in terms of social considerations. Even with an established taxonomy there will still be elements relating to ESG factors which are subjective. ESMA may wish to consider whether their proposed drafting adequately addresses this point.

Firms have significant concerns about meeting their obligations during the period, (which is a number of years), when the taxonomy has not been established for each of the components of ESG. In particular firms are unclear about the interaction between the three components of ESG where the taxonomy is only available for one component.

In the event you have any queries on the content of our response please do not hesitate to contact us.

Yours sincerely

Ian Cornwall
Director of Regulation
Q1: 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 suggested approach and the changes in Article 21. However, it would be helpful, particularly for smaller firms, if ESMA could subsequently publish some Q&As with examples illustrating where ESG considerations are relevant in the provision of investment services.

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.

In respect of the content of paragraph 9, our understanding is that the taxonomy will never cover company shares traded on regulated markets. It would be helpful if ESMA could confirm whether or not our understanding is correct. It is unclear from the supporting material how ESMA expect firms to address ESG issues in the context of company shares. We note the comments in paragraph 10, however we are unclear as to the evidence supporting the comments. Our understanding is that if an economy transitions to a low carbon economy as suggested in the CP, then it is likely that low carbon economic activity will be reflected by companies represented in mainstream benchmarks. Consequently we are unclear as to the basis for the statement in the CP that, ‘Similarly, firms providing investment advice may want to consider the long-term impact on client returns of investing in mainstream benchmarks relative to low-carbon alternatives, as the EU economy and broader investment community transition to a low-carbon economy’.

We are supportive of the change to Article 23.

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 relation to sustainability considerations?

We agree with the suggested approach.

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 comment.

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.
The work that has been undertaken by manufacturers and distributors by the European Working Group (‘EWG’) on Product Governance in respect of mainstream European funds following the implementation of MiFIDII has highlighted the need for very clear and precise definitions of target market and cost data. The introduction of ESG preferences should have regard to the fact that data will invariably be codified and the data disseminated by data providers to distributors. We do not believe that relying on current market standards and labels is a satisfactory approach.

In respect of product governance, the European Working Group (EWG) was a collaborative approach between manufacturers and distributors to ensure there was a common understanding of the data fields, for example in respect of target market descriptors, and that all stakeholders were applying the same definitions. It was notable that at the outset of the project different stakeholders and individual firms had different understandings as to what the detailed data fields meant. There needs to be a common approach for describing ESG positive products.

Q6: 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 agree with the suggested approach.

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 and why.

We would refer you to our response to Q5 which should be addressed in revised Guidelines. We have some feedback from investment firms as to whether such a product actually exists in the market.

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

It would be helpful if there was a further case study where the product risk level was high to illustrate the interaction between the overriding obligation to meet suitability obligations and consideration of a client’s ESG preferences. For example, where a client has a low risk appetite/capacity for loss, but only medium or higher risk ESG compatible investments are available for investment. In such instances our understanding is that firms are not obliged to recommend the investment, since ESG preferences do not over-ride core suitability considerations, and that (subject to the firm’s terms) this may legitimately result in the firm advising the client to invest in something that is not ESG-compatible. In addition it may be helpful to have further case studies covering other financial instruments that are within scope such as bonds.

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.
Our member firms have raised questions as to whether ESG factors are to be considered as a whole or by reference to the individual components and questions have arisen as to what steps should be taken where there are issues with one element of the three components. We have no detailed observations on the approach to be adopted. However, we would emphasise the point we have already made of the importance of ensuring manufacturers and distributors adopt a common approach.

Q10: 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.

We would refer you to our response to Q5.

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

We agree with the proposed approach. We would refer you also to our response to Q5 above.

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 performed in such cases.

There needs to be a common agreement as to what firms are seeking to assess. We envisage there will need to be a dialogue with clients explaining what factors the investment firm considers to be covered by environmental, social and governance criteria. At present firms are still seeking to understand their obligations and are not yet in a position to specifically state whether they would assess environmental, social and governance criteria separately from each other or as single preferences.

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

We agree with the suggested approach.

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.
We note the statement in the CP that ‘The costs for firms of integrating ESG factors in their internal processes and in their investment decisions and advisory processes are expected to remain relatively limited.’ Feedback from our member firms suggest that the costs will be significant. Issues identified include:-

- Staff training
- Significant amendments to systems capturing client information
- Additional data costs
- Costs of producing client literature
- Revision of management information and portfolio monitoring systems
- Establishing contact with existing clients to ascertain ESG preferences
- Revising product governance procedures to take account of ESG preferences