INVERCO’S COMMENTS ON ESMA’S CONSULTATION PAPER ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MIFID II

GENERAL COMMENTS

The purpose of these proposals is very positively valued since these amendments aims to clarify to all authorized fund managers subject to the UCITS and AIFMD regimes (here in after, “authorized entities”) how to integrate sustainability risks within their internal processes. Moreover INVERCO welcomes ESMA’s suggestions that as critical prerequisite for an orderly development, the taxonomy should be finalized before review financial regulations.

INVERCO wants to highlights that the integration of sustainability risks is a new and complex material for the financial sector, and in particular for the asset management industry, for which it will be a great challenge, in a context of narrowing margins and increasing costs. For this reason, it is so important, to avoid unnecessary costs and legal uncertainty for entities and investors, that the sector’s interest is addressed through these two ESMA’s consultations.

Accordingly, we believe that the review of MIFID II regulations should consider the following key principles:

1. **Develop a mature legislative process prior to review financial regulations**

The legislative process needs to be more mature before trying to apply ESG or sustainability risks in any sectoral regulation (such as intended with the Commission’s amendments to the delegated act supplementing MIFID II). Two clear examples:

(i) **Integration of ESG factors in the investment decision-making process before having a defined taxonomy.** That is Sequential approach needs to be followed, first regarding taxonomy and an appropriate disclosure as it will clearly define what it is understood as sustainable; and second, incorporating ESG considerations in other parts of the financial regulations.

(ii) **Integration of sustainability risks in the risk management process, without alignment throughout the legislative package the notion of “sustainability risk”**.
2. Integration requirements for ESG factors and sustainability risks based on the high level principles of flexibility and proportionality:

Inverco fully agrees with ESMA's approach that the requirement to integrate ESG factors and risks in the entities' organization is reflected in the regulations under an approach based on the high level principles of flexibility and proportionality, allowing it to the authorized entities to, depending on their size, type and complexity of their activities, ensure their integration in the way they deem most convenient.

Based on this legislative ESG proposal, the industry faces a particularly dynamic matter, not only because it is a complex and groundbreaking legislative package that advocates for a gradual implementation, but also because even when the legislative process is finalized, the Taxonomy or classification of activities with sustainable impact, on which the entire ESG regulation pivots, will remain a living tool that will undergo continuous changes to integrate new activities into it.

Therefore, flexibility allows for coordination and compliance in a way and to a degree that facilitates the obligation to integrate ESG factors and sustainability risks within the organization in an appropriate manner. Indeed, flexibility enables entities to adapt their organizations in a more rational, quick and easy way to changes when necessary, reducing both the cost involved in reviewing processes and systems and the legal uncertainty of continuous or disproportionate changes.

3. Horizontal integration of ESG factors in the organization, processes and controls:

We believe that the integration of sustainability risks and ESG factors in the organization of the entities should be a horizontal integration, so that the ESG aspect is taken into account as one more factor in the different business lines or control affected, without adding an additional layer ESG that duplicates processes. This horizontal integration would be achieved through awareness and training programs for affected personnel. Therefore, as a general rule, we are not in favor of appointing qualified person for ESG. Nevertheless, in application of the principle of proportionality, the appointment of such a qualified person will depend on the activity of each entity and its degree of dedication to manage sustainable products.

4. Align Level 1 regulation and level 2 regulations:
We consider it is absolutely necessary to completely align Level 1 regulation and level 2 regulations, especially the proposal of sustainable finance disclosures and the Non-Financial reporting Directive (NFRD) and those on which the modifications of the level 2 regulations are based (delegated acts UCITS, AIFMD and MiFID II), ensuring consistency and legal certainty when applying the different texts to the same processes and areas within the asset management activity of the entities.

The impact of divergent approaches is particularly important noticeable in 2 areas:

- **The concept of "sustainability risk"**: while in the NFRD "sustainability risk" is understood as the adverse impact that a specific economic activity can have on society from an environmental, social and employee matters, the "sustainability risk" concept to which ESMA refers in its proposal to modify the level 2 regulation is a financial risk, that is, the financial impact that ESG factors could have on a certain investment, or as ESMA literally indicates "the risk of fluctuation in the value of positions in the fund's portfolio", as well as the exposure that this investment has to any other financial risk, such as liquidity, market or counterparty risks.

- **Principle of proportionality through the expression "where appropriate" or "where relevant"**: Although ESMA's intention is clear when it comes to wishing to introduce ESG factors into the organizational structure of the entities in a proportionate manner, using the expression "where relevant" in the MiFID II Level II regulation (Delegated Regulation 2017/565 and Delegated Directive 2017/593) and III (Guidelines on MiFID II product governance requirements and Guidelines on suitability), this intention is not clearly demonstrated in the proposed changes to the Level 2 of the UCITS and AIFMD regulations. The same applies to the proposals drawn up within the framework of the Action Plan 4, related to the proposal of sustainable finance disclosures, where the duties of institutional investors are set out with such an impact and transcendence in level 1 (i.e. the measurement of ESG factors in the profitability of financial products or the inclusion of ESG factors in the remuneration policy) that is even higher than in delegated acts.
The same alignment on the approach and principles needs to be maintained between ESMA’s proposal to modify Level 2 of MIFID II (Delegated Regulation 2017/565) and the proposal of the European Commission that modifies other provisions of this same regulation.

5. **Ensure uniformity and gradual application**

Taking into account national ecolabels are very varied across Europe the establishment of an EU Taxonomy and creating European cross-border standards and labels for investments products are crucial in order to avoid any lack of clarity and duplicities of costs due to these parallel eco/sustainable labels or market standards. INVERCO would therefore recommend that firms shouldn’t rely on current market standards in order to integrate sustainability risks into their existing, internal processes and decision-making until the wider EU taxonomy is defined.

INVERCO additionally believes that firms when identify the target market of the products and ESG preference’s clients should focus on general approach (with a single ESG indicator) as a vital first step. And only when market is sufficiently mature, as second step, a more granular approach (environmental, social and governance factors being separately from each other) would therefore be applicable to comply product governance and suitability requirements.

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.

In regard to the obligation to integrate ESG factors and sustainability risks within the entities’ organization INVERCO fully supports ESMA’s approach based on high level principles, mainly principles of flexibility and proportionality, leaving it to the entities, depending on the size, type and complexity of their activities, to ensure the integration of ESG factors in the way they deem most convenient.

Based on this legislative ESG proposal, the industry faces a particularly dynamic matter, not only because it is a complex and groundbreaking legislative package that advocates for a gradual
implementation, but also because even when the legislative process is finalized, the Taxonomy or classification of activities with sustainable impact, on which the entire ESG regulation pivots, will remain a living tool that will undergo continuous changes to integrate new activities into it.

Therefore, flexibility allows for coordination and compliance in a way and to a degree that facilitates the obligation to integrate ESG factors and risks within the organization in an appropriate manner. Indeed, flexibility enables entities to adapt their organizations in a more rational, quick and easy way to changes when necessary, reducing both the cost involved in reviewing processes and systems and the legal uncertainty of continuous or disproportionate changes.

In addition, it is absolutely necessary to completely align Level 1 regulation and level 2 regulations, especially the proposal of sustainable finance disclosures and the Non-Financial reporting Directive (NFRD) and those on which the modifications of the level 2 regulations are based (delegated acts UCITS, AIFMD and MiFID II), ensuring consistency and legal certainty when applying the different texts to the same processes and areas within the asset management activity of the entities.

The impact of divergent approaches is particularly important noticeable in 2 areas:

- **The concept of "sustainability risk"**: while in the NFRD “sustainability risk” is understood as the impact that a specific economic activity may have on society from an environmental and social point of view, the "sustainability risk" concept to which ESMA refers in its proposal to modify the level 2 regulation is a financial risk, that is, the financial impact that ESG factors could have on a certain investment, or as ESMA literally indicates "risk of fluctuation in the value of an investment due to ESG factors ", as well as the exposure that this investment has to any other financial risk, such as liquidity, market or counterparty risks.

- **Principle of proportionality through the expression "where appropriate" or "where relevant"**: Although ESMA’s intention is clear when it comes to wishing to introduce ESG factors into the organizational structure of the entities in a proportionate manner, using the expression "where relevant" in the MiFID II Level II regulation (Delegated Regulation) and III (Guidelines ...), but this intention is not clearly demonstrated in the proposed changes to the level 2 regulations of UCITS and AIF.
The same applies to the proposals drawn up within the framework of the Action Plan 4, related to the proposal of sustainable finance disclosures, where the duties of institutional investors are set out with such an impact and transcendence in level 1 (i.e. the measurement of ESG factors in the profitability of financial products or the inclusion of ESG factors in the remuneration policy) that is even higher than in delegated acts.

The same alignment on the approach and principles needs to be maintained between ESMA’s proposal to modify Level 2 of MIFiD II (Delegated Regulation) and the proposal of the Commission that modifies other provisions of the same regulation.

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.

As we stated in question 2, INVERCO welcomes ESMA’s wider, flexible and high-level approach on this issue. Nevertheless, it is important and urgent for INVERCO to make a sound warning to regulators and policy makers on the risks that lie beneath two proposal on the same matter (ESMA’s proposal to modify Level 2 of Delegated Regulation 2017/565 of MiFiD II and the proposal of the European Commission that modifies other provisions of this same regulation) that do not align with each other and the difficulty that will entail for the industry to prepare for correct compliance.

In this regard, it is of utmost importance that any amendment to the MiFID II Delegated Regulation should come out as one coordinated proposal and with a single application date, since a fragmented approach will only make it harder to be adopted in a proper way.

Besides, INVERCO stresses the need to take into account the flexibility and proportionality principles, not only when drafting the relevant amendments but also by bearing them in mind when elaborating the application timeframes, so that financial institutions all over the EU may be able to integrate this obligations in a gradual and adaptable manner suitable to each organizational reality.
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?

Although we agree with ESMA that ESG considerations should not lead to mis-selling practices or misrepresentations and does not damage the interest of the client, ESG considerations should be treated as like any other risk and for that existing rules are sufficient. Therefore INVERCO believes that no specific recitals should be necessary.

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.

INVERCO considers that no other amendments are necessary.

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 we stated on general remarks firms shouldn’t rely on current market standards or national ecolabel. Before adopting any measure, Taxonomy should be finalized as a crucial first step. INVERCO additionally believes that firms when identify the target market of the products and ESG preference’s clients should focus on general approach (with a single ESG indicator) as a vital first step. And only when market is sufficiently mature, as second step, a more granular approach (environmental, social and governance factors being separately from each other) would therefore be applicable to comply product governance and suitability requirements.
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.

INVERCO generally agrees with ESMA’s approach but also suggests that any approach regarding ESG preferences should not become too granular. If the level of analysis of the ESG factors is too deep, investors will end up with information that requires too much analysis and therefore too costly to understand.

Furthermore, from our perspective, taxonomy does not really help indicate ESG preferences for retail investors. Indeed, a taxonomy approach is too complex and would probably overburden investors not allowing them to identify correctly environmentally sustainable investments.

So as stated in the previous question, INVERCO believes that a single ESG indicator should be easier to set preferences for retail investors and it will avoid information overload as a first step. And only when market is sufficiently mature, as second step, a more granular approach (environmental, social and governance factors being separately from each other) would therefore be applicable to comply product governance and suitability requirements.

On the other hand, in practice, the industry will attempt to integrate these new requirements into the existing European MiFID II Template (EMT), which will take time since it requires all the stakeholders to agree.

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.

INVERCO welcomes the ESMA’s proposals to include a simple reference regarding “ESG preference” in the Level II and to develop the principles in product governance Guidelines as level III.

Additionally, INVERCO supports ESMA’s suggestion that ESG criteria do not have a negative target market.
Lastly, it should be worth considering the implications that the relevant amendments on the MiFID II Delegated Directive may imply on ESMA’s guidelines, therefore proper attention should be paid to a proper consolidated approach between ESMA’s proposal and Commission’s proposal.

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

INVERCO fully with ESMA’s confirmation that ESG considerations should not be relevant as a factor of a negative target market. Therefore, INVERCO sees additional guidance are welcome in order to clarify and help entities to have a better and common understanding of the regulation.

**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.**

So as stated in previous questions, INVERCO believes that a single ESG indicator should be easier to set preferences for retail investors and it will avoid information overload as a first step. And only when market is sufficiently mature, as second step, a more granular approach (environmental, social and governance factors being separately from each other) would therefore be applicable to comply product governance and suitability requirements.

**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.**

According to question 5, INVERCO would recommend that firms shouldn’t rely on current market standards in order to integrate sustainability risks into their existing, internal processes and decision-making until the wider EU taxonomy is defined.
INVERCO fully agrees with ESMA’s suitability approach in two steps (see paragraph 11 page 23 ESMA Consultation on integrating sustainability risks and factors in MIFID II) since we believe this approach avoids mis-selling practices. At the same, INVERCO agree with ESMA approach that:

- ESG investment should automatically be deemed unsuitable for clients that do not have ESG preferences.
- Investment that are not categorized as ESG investment should automatically be deemed unsuitable for clients who have expressed ESG preference.

Additionally and in line with our previous comments, INVERCO believes that it should be easier to start initially with a single ESG indicator to set preferences for retail investors and when market is sufficiently mature, a granular approach would therefore be applicable.

Since ESG criteria are not mutually exclusive and they are highly intertwined, INVERCO believes that it should be easier to start initially with a single ESG indicator to set preferences for retail investors and when market is sufficiently mature, a more granular approach (environmental, social and governance factors being separately from each other) would therefore be applicable to comply product governance and suitability requirements.
INVERCO agrees with the suggested approach, however, it should take into account the Commission’s clarification on the draft MiFID II Delegated Act which clarified that a new suitability assessment for existing contracts will generally not be necessary (see Recital 8).

Thus, it would be of great help if ESMA clarifies that the reference to existing clients in paragraph 17 of the consultation paper is to be read only in the context of ongoing monitoring of the relationship with the client and not as requiring a re-assessment for all clients regardless of the contract.

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

No comment

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.