19 February 2019

The European Securities and Markets Authority  
103 rue de Grenelle  
75345 Paris Cedex 07  
France

Via online submission: www.esma.europa.eu

Dear Sir/Madam,

**State Street Global Advisors’ response to ESMA’s consultation on integrating sustainability risks and factors in MiFID II**

State Street Global Advisors welcomes the opportunity to comment on the European Securities and Markets Authority (ESMA) consultation paper on integrating sustainability risks and factors in the Markets in Financial Instruments Directive (MiFID) II. State Street Global Advisors is the asset management arm of State Street Corporation, one of the world’s leading providers of financial services to institutional investors. With over $2.81 trillion of assets under management ("AUM") across a range of asset classes and investment styles, State Street Global Advisors is the world’s third largest asset manager.

Asset managers are increasingly integrating sustainability into their investment process. This means having sustainability experts working alongside portfolio managers and analysts to consider whether material environment, social, and governance (ESG) factors contribute to or detract from the value of a given investment opportunity. It also involves stewardship, where asset managers engage with companies through dialogue and proxy voting on all aspects of strategy, business model and investment in order to build a mutual understanding of the material risks facing the company while ensuring such externalities are integrated. Incorporating material ESG considerations is part of our duty to act in the best interest of our clients. Such risks vary based on the market, sector and geography of a given company, as well as their individual business models. Understanding the context in which companies operate is key to developing a long-term risk/reward assessment.

With this in mind, ESMA’s high-level principles-based approach to integrate ESG risks and factors in MiFID II is very much welcome. A proportionate, flexible approach will ensure that existing sustainable investment approaches are not disrupted. While we have contributed detailed comments to industry responses, there are two particular areas that we think warrant careful consideration by ESMA, namely: i) the defined concepts and terms in relation to ESG as well as broader sustainability matters; in addition to ii) the overall legislative framework and implementation timeline.

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1 AUM figure listed is as of 30/09/2018. AUM reflects approx. $28.32 billion USD (as of 30/09/2018) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; SSGA FD, LLC and State Street global Advisors are affiliated.

2 The Investment Company Institute (ICI) Global, the European Fund and Asset Management Association (EFAMA), and the UK Investment Association.
**Sustainability-related definitions**

To promote consistency and harmonisation across the investment industry, and to achieve the best outcomes for consumers, concepts and terms relating to environmental, social, and governance (ESG) as well as broader sustainability matters must be clearly defined. We have interpreted such concepts and terms used in this consultation consistently with the European Commission’s amendments to the MiFID Delegated Regulation, which were drafted in parallel. Absent, however, is a common definition for “sustainability risks” across the various amendments to MiFID legislation by both the EU Commission and ESMA. This extends to similar efforts by the European Insurance and Occupational Pensions Authority on Solvency II and the Insurance Distribution Directive. We appreciate that the lack of a clear definition could be indicative of the European institutions’ discussions on legislative proposals that aim to introduce a unified classification system for sustainable economic activities and to enhance investor duties/disclosures, given their views on such risks differ. However, in ESMA’s consultation paper on integrating sustainability risks and factors into the UCITS and AIFMD frameworks which states sustainability risks “could be understood as the risk of fluctuation in the value of positions in the fund's portfolio due to ESG factors.” We think ESMA could effectively contribute to the wider debate by providing an unambiguous definition within its technical advice due to be delivered to the Commission, along the lines of the one set out above as it links sustainability risks to the financial value of an investment. Although, we have comments about the precise definition that ESMA has adopted in our response to that separate consultation.

**Legislative framework and timing**

In view of the legislative timeline envisaged in the European Commission’s Action Plan on Sustainable Investments, we support the development of a principles-based framework. Sufficient clarity is needed from regulators to ensure manufacturers and distributors have the same understanding of the overall regulatory intention, particularly given the European MiFID Template (EMT) has become the standardised means by which information is exchanged in accordance with the MiFID II Delegated Directive. As ESMA indicates, certain adjustments will be required as the market matures, and so competent authorities should be susceptible to different approaches. A suitable implementation period of 18-24 months would be necessary. There will be significant work to achieve agreement on an updated EMT format, subsequent analysis to assess characteristics of manufacturers’ products, and to issue revised target market information.

Please find enclosed detailed views on the specific questions raised. Should you wish to discuss this submission further, please do not hesitate to contact me.

Yours sincerely,

Nigel Aston
Senior Managing Director
State Street Global Advisors
Detailed comments on specific questions

Question 1: Do you agree with the suggested approach and the changes to Article 21 of the MiFID II Delegated Regulation on ‘general organisational requirements’?

We agree with the spirit of the proposed approach and specific amendments to Article 21 of the MiFID II Delegated Regulation. This will ensure broad integration of ESG considerations into the organisational requirements, which are deliberately general and refer to the organisational fabric of a firm.

Such an approach is particularly important when considering the provision of discretionary portfolio management because investment managers act according to the mandate ceded by its client and defines clear lines of responsibility.

Question 2: Do you agree with the suggested approach and the changes to Art 23 of the MiFID Delegated Regulation on ‘risk management’?

In addition to further consideration on the definition of sustainability risks, ESMA may wish to provide further guidance around the expectation of risks and activities to be considered. We think this would help firms in their determination of metrics and tolerances for risks.

In line with the stated aim of the amendment in paragraph 10 of Section 2, the proposed amendment to Article 23 of the Delegated Regulation should note the nuance that the risks should be considered where they relate to the provision of an investment service. In relation to monitoring investment risks, firms will need to obtain ESG data on individual instruments or issuers, and this data will need to be integrated into a scalable risk-monitoring framework. Until such time as the unified classification system for sustainable economic activities is in place and operating effectively, instrument ESG data sourced by investment managers from third-parties may not be in line with the European Commission’s proposed definitions. That said, we currently use multiple third party sources and the Sustainability Accounting Standards Board (SASB) materiality framework in order to obtain best-in-class data. We therefore think that there must still be flexibility in the assessment of sustainability risks, and alignment with international efforts.

Question 3: Do you agree with the suggested approach and the new recital on ‘conflicts of interest’? What would be specific examples of conflicts of interests that might arise in relation to sustainability considerations?

In proposing specific requirements in relation to the identification of conflicts of interest and the inclusion of sustainability factors in that process, there are certain aspects that we ESMA should consider. As stated, for discretionary portfolio management services, investment managers are acting in accordance with the mandate given to them by their client. Therefore, we foresee very limited circumstances under which a conflict arising from an ESG matter would occur between the firm and client. This is especially relevant considering ESMA is proposing to ensure ESG is on the table at the commencement and review of such a mandate. Furthermore, in the event that a client’s mandate could give rise to a diminution in value due to ESG factors and provided that the investment manager had acted in accordance with that mandate, we do not think it is appropriate for the firm to be responsible for disclosing or mitigating those effects.
Question 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?

We do not think further amendments are necessary.

Question 5: Which existing market standards or “labels” are you intending to take into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or “labels”?

As a starting point, we refer ESMA to an effective framework established by the Sustainability Accounting Standards Board (SASB). The SASB framework effectively identifies 26 financially material indicators\(^3\) that are likely to impact the financial condition or operating performance of a company and thereby reasonably likely to affect an investment or voting decision. SASB also published its approach to determining materiality for the purpose of standard setting, although makes clear that it is the reporting entity which is responsible for such determination. Although developed in the United States, it has been mostly companies located elsewhere that have adopted the framework in order to mitigate risks arising from climate change and other sustainability issues.

Question 6: Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Directive Articles on “Product Governance”?

We are supportive of ESMA’s suggestion that the six environmental objectives specified in the taxonomy proposal could be used to substantiate the ESG characteristics of a product.

In paragraph 11 of the Suitability section of this consultation, ESMA notes it is important that sustainability considerations contribute as an additional aspect to suitability criteria, but they must not outweigh the relevance of the other suitability criteria in a way that might not result in the client’s best interest. In our opinion, the product governance considerations should be viewed in the same way. ESG considerations are not a factor in determining a negative target market in the sense of ensuring investor protection in the same way as the other factors currently considered. Instead, they provide additional information about how they conform to investor preferences rather than evaluate an investor’s ability to understand the product or evaluate whether the investor can bear losses. Furthermore, funds with an ESG objective may be attractive to investors with no ESG preferences, and funds that do not pursue an ESG objective may nevertheless be suitable to investors with ESG preferences. To this end, we do not see significant value in requiring distributors to report on a negative market in relation to ESG considerations.

At this stage of the market’s development, in arriving at an assessment of a financial instrument’s ESG characteristics, manufacturers of UCITS or AIFs should consider the fund’s overall contribution to the specific ESG objectives rather than the characteristics of each individual instrument in the portfolio. As data becomes more consistent and readily available, asset managers can integrate it more fully into their analytical tools.

Against this backdrop, we suggest the following adjustments to ESMA’s proposed amendments to the Delegated Directive:

\(^3\) ‘SASB Materiality Map’, The SASB Foundation, https://materiality.sasb.org/, published in 2018
• Article 9(11) (b) – replace the word “consistent” with “compatible” in order to better express the space for overlap between ESG focused-funds and other investor needs, and vice versa.

• Article 10(5) – amend the final sentence to say “Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes, or ceases to meet ESG characteristics.”

Question 7: Do you agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements and the addition of a case study?

As mentioned, given the varied levels of consumer knowledge and harmonisation around terminology in the market, we suggest that there is sufficient flexibility within the proposed framework such that direct investors and distributors can prioritise needs of a product. In some instances, those preferences may be mutually exclusive or there may be an overlap, but manufacturers cannot make that judgment. We therefore suggest creating a point (f) in paragraph 18 of the guidance to list the definitions and scope included in the taxonomy proposal. It would provide the necessary common understanding between manufacturers and distributors to aid transmission of the information between the two parties:

f) In considering the wider goals or preferences or a target client the firm should specify the ESG characteristics of the financial instrument in line with the Commission’s work on a unified EU classification system of sustainable economic activities (“taxonomy”). In doing so, the firm should state whether the following activities are addressed:

- i. Climate change mitigation
- ii. Climate change adaptation
- iii. Sustainable use and protection of water and marine resources
- iv. Transition to a circular economy, waste prevention and recycling
- v. Pollution prevention and control
- vi. Protection of healthy ecosystems
- vii. Social investments [per the revised amendment to the MiFID Delegated Regulation]
- viii. Good governance investment [per the revised amendment to the MiFID Delegated Regulation]

We broadly support the inclusion of an additional case study, but the current proposal requires some work to make it more relevant. If the fund invests mainly in loans, one would suggest that it is most likely to be an alternative investment fund, and more readily suitable to a professional investor, in which case it would not require a KID or KIID.

Questions 8 - 14

We have no comments on these questions.