Consultation Paper
On integrating sustainability risks and factors in MiFID II
Response of the 2° Investing Initiative

Question 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 don’t agree with the suggested approach as we believe that it increases confusion about the
nature of the obligations and their objectives.

It is unclear what ESMA refers to by “taking into account ESG considerations where relevant”.
When making recommendations ESMA should be very clear to specify, what it means with “ESG
considerations” and what the intended motivation of their “inclusion” is, i.e. how this relates to
the overall objective of consumer protection.

Explanation: Two motivations are possible and need to be clearly distinguished:

(for more detail, charts and references see the Portfolio Carbon Initiative report on “Climate
Strategies and Metrics”:

跚 The carbon-risk motivation: i.e. relative to managing financial risks: three types of
potential financial risks for investors are associated with climate change: (1) physical risks to
assets, (2) financial risks associated with climate mitigation policies and technological or
economic trends, and (3) potential legal liabilities. There is growing evidence that the
nonphysical risks, often termed “carbon asset risks,” may become material, though their
timescale is unclear. Equity research analysts from Kepler- Cheuvreux, HSBC Global
Research, Carbon Tracker Initiative, and Mercer, among others, are demonstrating the
potential impact of the energy transition on the valuation of high-carbon companies.
Climate-related investor activities may be seen as a response to these risks.

跚 The climate-friendliness motivation: i.e. relative to non-financial investment preferences
of investors. Climate change goes beyond the question of financial risk and is largely based
on external pressure to contribute to the transition to a low- carbon economy. Climate
change is increasingly seen as a norms-based issue among investors, and some see COP21 in
Paris in 2015 as an opportunity to take a public stand. In addition, public pension investors
frequently include environmental, including climate, objectives in their mandates or core
missions Investors increasingly feel public pressure through nongovernmental organizations
(NGOs) like 350.org and the divestment movement, and the Asset Owner Disclosure Project
(AODP).

Yet achieving the two motivations requires two independent strategies. Indicators commonly used in
a carbon-risk perspective (e.g., net margins, exposure to high-cost, high-carbon capital expenditure)
may not be correlated with indicators commonly associated with climate-friendliness objectives
(e.g., fossil fuel reserves, fuel efficiency of cars).

Two examples demonstrate why the motivations require different approaches and metrics:
1) Oil & gas: Exposure to high-cost (over US$85 per barrel of oil) projects is commonly seen as an indicator of an oil company’s exposure to carbon risks. However, this indicator is not correlated with the company’s carbon intensity (carbon content of reserves / market cap), a commonly used indicator for climate-friendliness objectives.

2) Automobile: The climate friendliness of car manufacturers may be measured by the average miles per gallon (mpg) of their fleet. But when assessing car manufacturers’ exposure to carbon risk, financial analysts look at their ability to pass on regulatory costs (e.g. a carbon tax) to consumers. These two indicators may be negatively correlated: high margins are obtained on fuel-inefficient luxury or sport cars whereas low margins are obtained on fuel-efficient small cars.

To best reflect the call for advice of the Commission the chosen objective may vary and depend on the related articles that are to be amended:

While indeed the extract from the Commission’s request for advice (mandate) seems to suggest a strong focus for a risk related objective, there is also evidence that the Commission is equally seeking to achieve climate-friendliness objectives which are linked to clearly specified targets.

The Commission Request for Advice states as the first overarching goal to:

“reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth”

The Sustainable Finance Action plan itself further specifies that the guiding principles for achieving sustainable and inclusive growth are the objectives set in the Paris agreement and the UN 2030 Agenda for Sustainable Development.

This formulation suggests that, besides the objective to manage financial risks, the Commission is also seeking to align financial flows with the Paris Agreement Climate goals and thus actively reorient financial flows to economic activities that are aligned. The same logic is applied to the SDGs.

A recent discussion on practical approaches to the objective to reorient capital flows:


How is this related to retail investors?

Various surveys on retail clients’ preferences clearly indicate that a large majority of them want their money to be used to generate environmental and social benefits. When asked about their motivation and expected outcomes, they answer that they want their influence as investors to be used to change the decisions in the real economy to deliver those outcomes. This seems to be aligned with the second objective to reorient capital flows towards sustainable investments as defined by the commission.

For the above-mentioned surveys please see for example:
ESMA should be very clear to specify what the underlying motivation for the inclusion of ESG issues is. An inclusion of a very general non-specified ESG reference into the Article 21 (1) risks to create more confusion than giving a clear direction of travel.

An example from discussions we had recently with representatives from financial institutions:

Using a general formulation as suggested could be interpreted by market players as the requirement to consult retail investors if they want ESG risks to be taken into account for their investments. First of all, there is no precedent for singling out one risk factor and giving the investor a say on which risk factor(s) he/she wants to be taken into account for the overall financial risk assessment.

Second, many market players actually claim that they assess ESG-related risks already as a standard factor in their risk assessment. Giving the investor the choice to opt-out of ESG risk assessments would make all investment products they offer non suitable. Given that the overarching objective is to protect the client from financial risks (no matter what the factor is that triggers them) such an approach seems to be contrary to the objective.

It thus needs to be clear that any approach related to assessing and including the clients’ preferences need to be strictly limited to their non-financial investment preferences, including the motivation to reorient capital flows to sustainable investments. Given the large prevalence of non-financial objectives according to the surveys cited above. It seems to be important for the objective of consumer protection and more specifically to avoid mis-selling, to ensure that the formulations used leave no doubt that such consumer preferences are expected to be identified and addressed by financial advisers.

As regards the motivation to include ESG factors in financial risk assessments, the important question in relation to market practices does not seem to be the question to whether to include ESG factors or not, but rather the how it should be done. The HLEG on Sustainable Finance specifically warned against using the broad concept of integration of ESG factors/risks but rather recommended the ESAs to mandate the extension of the time horizon of the risk analysis in line with the time horizon of beneficiaries’ investments (See table on page 42 of the HLEG Final report). This would allow the risk analysis to capture all long-term, non-linear and non-cyclical risks (including any ESG related risks such as climate related risks).

We therefore recommend following the recommendation of the HLEG. If however, it is maintained to single out ESG related financial risks, then the time horizon of the risk analysis should be extended in order to capture such risks more effectively. For more detailed analysis see: 2° Investing Initiative.

**Recommendations on the general approach:**

Even if there is still an ongoing debate on the best metrics/practices/taxonomies to use, definitions for both overarching motivations need to be added in the definition section of each text to be amended, e.g.:

Managing ESG-related risks means the reduction of the exposure to financial risks and identifying financial opportunities related to ESG issues.

Reorienting capital flows towards sustainable investments means the identification and pursuance of approaches to change the allocation of financial flows in the real economy in order to align financial flows with the Sustainable Development Goals.

Non-financial investment preferences of clients are preferences with regard to the allocation of the investment within the identified appropriate risk category.

**ESMA recommendations should then clearly specify the objective(s) related to each of the articles that financial institutions are supposed to pursue with the ESG integration.**

This is consistent with the principle-based approach. Level 1 and 2 regulation set clear principles/motivations to follow. Given the little established market practices much more detailed guidance through level 3 documents should be developed and can in the following be more frequently adapted to ensure that they reflect the latest developments on metrics and instruments in order to best meet the specified objectives. Such an approach could largely facilitate not only the operationalization of the intended regulatory changes by the regulated entities but also the oversight and enforcement activities by regulators. Additionally, it will also support the aim to avoid legal uncertainty and at the same time leave room for innovation by market actors as recommended by the SMSG.

**Specific recommendations related to general organizational requirements**

Add a new paragraph 5 in Article 21:

“Investment firms shall establish, implement and maintain adequate policies and procedures that enable them to pursue the effective management of (ESG-related) financial risks in line with the time horizon of their clients and recommend and design products in accordance with their client’s non-financial investment objectives.”

Existing paragraph 5 becomes paragraph 6 and is rephrased accordingly:

“(5) 6. Investment firms shall monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms and arrangements established in accordance with paragraphs 1 to (4) 5, and take appropriate measures to address any deficiencies.”
Question 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.

The HLEG on Sustainable Finance specifically warned against using the broad concept of integration of ESG factors/risks but rather recommended the ESAs to mandate the extension of the time horizon of the risk analysis in line with the time horizon of beneficiaries’ investments (See table on page 42 of the HLEG Final report). This would allow the risk analysis to capture all long-term, non-linear and non-cyclical risks (including any ESG related risks such as climate related risks).

Related to the taxonomy under development, it is still too early to say if the metrics developed can be used for climate risk assessment. The current approach seems to be not intending to cover “brown” assets at least in the first instance. TEG members underlined that technologies that are not yet covered by the taxonomy cannot be automatically considered to be “brown” assets. As long as brown assets are not covered by the taxonomy it can by definition not be used for the identification of potentially risky assets, even if carbon intensity is only one factor among many others to identify carbon risks. For a more in-depth discussion on carbon risk assessments, see:


And the Energy Transition Risk Assessment Toolbox: [http://et-risk.eu](http://et-risk.eu)

Recommended wording:

(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, investment firms shall take into account environmental, social and governance factors, align the time horizon of their risk assessment to the time horizon of the clients’ investments.
Question 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?

Various surveys on retail clients’ preferences clearly indicate that a large majority of them want their money to be used to generate environmental and social benefits. When asked about their motivation and expected outcomes, they answer that they want their influence as investors to be used to change the decisions in the real economy to deliver those outcomes. This seems to be aligned with the objective to reorient capital flows towards sustainable investments as defined in Q1.

For the above-mentioned surveys please see:

- yet unpublished results of a 2° Investing Initiative survey of German retail investors: [https://www.dropbox.com/s/c5bcmi3j63a7n24/Results%20Survey%20German%20Retail%20Investors.pdf?dl=0].

Most ESG products are not associated with “sustainability impacts”. As noted by the HLEG Final Report (p. 10), most ESG-related products on the market today have not been designed with the objective of influencing the decisions of players in the real economy (e.g. request investee companies to align their investment plans with climate goals). They are primarily designed to marginally integrate financial risks related to ESG factors, by reducing the exposure to risky activities and increasing the exposure to green activities (e.g. green funds, low carbon ETFs, etc.). However, as discussed in Q1 these two motivations are fundamentally different, and most investment strategies developed to mitigate ESG-related risks are ineffective when it comes to triggering changes in the real economy.

As a result, there is a fundamental mismatch between the current offer of ESG products on the market, and the non-financial investment objectives of retail investors, as revealed by various surveys. In other words: most existing ESG products would not pass the suitability test if the questions were correctly framed. A new generation of ‘sustainable impact investment’ products, including insurance undertakings, will need to be developed.

The most likely conflict of interest will hence be that financial institutions providing financial advice will advocate for a vague framing of any new obligation such as ‘integration of ESG factors’, in order to be able to sell existing ESG products despite their unsuitability, and benefit from the rent created by the regulation without having to adapt their processes.

That is one of the reasons, why we advocate to clearly define the motivation from the start. If the definitions are clear, then the metrics can follow. The effectiveness of a new recital on the topic,
however, is unclear, specifically if it included wording that is not clearly defined (see also our discussion of potential misunderstanding created in Q1).

**Recommendation:**

Key to avoiding this conflict of interest will be the provision of clear guidance on how to assess the non-financial preferences of retail clients in the framework of the suitability assessment. As ultimately the client is supposed to define the level of ambition with regard to the objective.

In order to provide a basis for discussion, we have been setting up a stakeholder working group in Germany to discuss potential approaches for a best practice questionnaire to assess client objectives with regard to their ESG preferences in the framework of the suitability assessment. The working group comprises the German regulator BaFin (observer), the German Government (Environment Ministry), as well as several representatives from financial institutions, NGOs and Universities. We are also planning to extend the exercise to France and the European level with dedicated working groups. We are happy to share the current state of discussions with ESMA staff and would be very happy to welcome ESMA representatives to our French/European working group from the start.

In general, we believe that it would be beneficial for ESMA to commission its own research in collaboration with universities to ensure an independent understanding of client’s needs and preferences. This would enable ESMA to design evidence-based requirements that limit conflict of interest and to cross-check financial institutions arguments against its own research results.

If a recital is maintained, then the wording should be adapted to be more specific:

*When identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments that are designed to respond to the non-financial investment preferences of clients.*

*Firms should have in place appropriate arrangements to ensure that the inclusion of ESG considerations non-financial investment preferences of clients in the advisory process and portfolio management does not lead to mis-selling practices.*
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? If yes, which ones? Please state the reasons for your answer.

Additions to Article 2 on definitions as suggested in Q1

Question 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.¹

We are concerned with the definition of “sustainable investments” applied to financial products currently proposed by the EC and used by most labelling initiatives. We think the definitions are flawed.

The problem is that most definitions equate “increasing the exposure of a portfolio to a green economic activity” with “contributing to the decarbonization of economic activities via an investment strategy”, which is the policy goal behind the EC Action plan (see also discussion in Q1). These two objectives are however very different:

- Investors can increase their exposure to green activities and have a negative influence on the development of these activities (e.g. a hedge fund buying a Tesla stock and pressuring the top management to cut investment and increase short term profits),

- On the other hand, investors can be exposed to “brown activities” and still have a positive influence on the reduction of carbon emissions (e.g. investors using their voting power to pressure high carbon companies to change their investment plans).

The definition currently proposed by the EC is over-simplistic: it only focuses on exposure to green activities only, while excluding investment strategies that use the influence on investees (via voting rights, conditionality of loans, etc.) that happen be the most popular among investors and banks.

Basing any label on such a definition will lead to include investment strategies that have no associated environmental benefits and excludes others that are associated with environmental benefits.

¹ An overview of existing national eco-labelling schemes has been included by the European Commission in Section 2.2.3 of its ‘Commission Staff Working Document – Impact Assessment’ [Ref: SWD(2018) 264 final]. These include:
- TEEC Label (France)
- FNG Siegel (Germany)
- Luxflag Climate Finance Label (Luxembourg)
- Swan Ecolabel (nordic countries)
Similarly, the taxonomy that is under development is currently focused on a logic of exposure and will therefore unlikely be useful for designing products that respond to clients with non-financial preferences to reorient capital flows towards sustainable investments.

That is the reason why we recommend an approach that clearly identifies the underlying motivation and leaves it to the manufacturer to use the best available metric that allows to make the match between the identified preference of the client and the product. As discussed in Q1 any formulation needs to be very clear that requirements cover only the non-financial preferences of clients and not the integration of financial risks.
Question 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.

In line with our argumentation in Q1 the wording should be:

*Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, including ESG non-financial preferences (where relevant), the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.*

Given the high prevalence of non-financial preferences among retail clients, it seems to be disproportionate to not ask investment firms to clearly identify products that do not cater to any non-financial preferences. This does not necessarily include to quantify the potential negative impact. However as a minimum requirement, the product could have a visible statement that it is incompatible for clients with non-financial preferences. We therefore recommend to strike the wording “where relevant”.

*Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:*

a) the financial instrument’s risk/reward profile is consistent with the target market; and
b) the financial instrument’s ESG characteristics related to non-financial investment preferences (where relevant) are consistent with the target market; and
c) financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable.

We propose to use wording along the same lines also for Articles 9(14), 10(2), and 10(5) of the MiFID II Delegated directive.
Question 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.

In line with the discussion above we suggest the following changes to the guidelines:

*Clients’ Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is designed to meet including ESG non-financial preferences of the client (where relevant) and the wider financial goals of target clients or the overall strategy they follow when investing.*

With regard to the inclusion of the case study, we consider that a simple case study will be enough to provide enough guidance on a topic of such complexity and relative novelty such as the definition of impact.

We recommend the establishment of clear guidelines on agreed approaches for investment products to generate impact in the real economy. Before such guidelines are developed and adopted product manufacturers should at least clearly explain how the positive impact is supposed to be created including a description of the additionality that the product triggers. A simple reference to a carbon footprint is not sufficient and providing such an example in ESMA guidelines risks to open the door wide to misselling.

A recent discussion on practical approaches to the objective to reorient capital flows:

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

Given the high prevalence of non-financial preferences among retail clients, it seems to be disproportionate to not ask investment firms to clearly identify products that do not cater to any non-financial preferences. As a minimum requirement, products that do not target any non-financial preferences should therefore include this in the identification of the negative target market.

Wording should be: “clients with non-financial investment preferences”

In addition, given the importance for generating impact for retail investors, products that do not have any explicit strategy to generate impact in the real economy should specify this in the identification of the negative target market. This relatively straightforward information of impact targeted or not, would be a massive step forward for product transparency and could prove to be decisive for the objective to avoid mis-selling.

Wording should be: “clients with non-financial investment preferences that include to create impact on the allocation of financial flows in the real economy”

Question 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.

See Q5
Question 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 welcome the proposed strengthening of the wording from a “good practice” to a specified requirement.

We disagree that firms should decide on their own how best to incorporate clients ESG preferences. There are very little existing market practices and the approaches developed by different market actors will go counter the overall objective to ensure a consistent level of services provided to clients across Europe. Moreover, we have already outlined in Q3 the high risk of conflict of interest leading to mis-selling. Therefore it seems very important to provide much more guidance for the suitability assessment related to non-financial investment objectives.

As already suggested above a cross stakeholder working group should be convened to develop clear best practice guidelines for the questions used to assess non-financial preferences.

Paragraph 28

When collecting information about their clients’ ESG non-financial preferences, firms should ask questions in relation to environmental, social and governance issues 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. In particular the firm should understand if the client has specific expectations in terms of the impact that his/her investments should create in the real economy.

Given that there seems to be both a widespread prevalence of preferences for impact and little offer on the existing product side, it seems to be clear that the identification of the preference for impact or not must become a minimum standard to avoid mis-selling on the one hand and guide new product development on the other hand.

We also suggest to not already require the consistency with the taxonomy under development, as it is unclear which direction the development is taking and if the final result will be relevant to the non-financial preferences of retail investors.
Question 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.

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

In line with our discussion above we suggest the following changes:

Firms should adopt robust and objective procedures, methodologies and tools that allow them to appropriately consider the different characteristics (including, the suitability for non-financial preferences where relevant, ESG considerations) and relevant risk factors (such as credit risk, market risk, liquidity risk\textsuperscript{17}, ...) of each investment product they may recommend or invest in on behalf of clients. This should include taking into consideration the firm’s analysis conducted for the purposes of product governance obligations\textsuperscript{18}. In this context, firms should carefully assess how certain products could behave under certain circumstances (e.g. convertible bonds or other debt instruments subject to the Bank Recovery and Resolution Directive\textsuperscript{19} which may, for example, change their nature into shares).