Dear Mr Rava, Ms Perard and members of ESMA's working group,

Please find attached our response to the Consultation Paper on integrating sustainability risks and factors in MiFID II (19 December 2018 – ESMA 35-43-1210)

Introduction

Ruffer LLP offers discretionary investment management and at present has £21.1 billion assets under management. We are authorised and regulated by the Financial Conduct Authority. Ruffer LLP is a limited liability partnership (LLP) owned by current and former members of staff. This structure aligns our interests with those of our clients by emphasising investment returns and client relationships that are sustainable over the long term. We are currently awaiting approval for a subsidiary in France which will ensure we continue to serve EU clients post Brexit.

Responses to the questions

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.

Ruffer would support the proposed changes to Article 21. Where ESG considerations are relevant and being provided by an investment organisation, it is, of course, important that there are appropriate processes, systems and controls in place.

We notice however, that ‘where relevant’ and ‘are relevant’ are used in different ways interchangeably. We think this leads to lack of clarity. We would suggest consistency and strongly advise any solution stress the needs of proportionality or these rules could disproportionately disadvantage smaller firms.
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.

The content of paragraph 10 states that an “investment policy that ignores environmental considerations leaves the possibility for clients to invest in stranded assets”. The focus on stranded assets in this context overstates the case. In fact, the question of stranded assets can arise in any investment context, for example the failure of Kodak to understand the impact of electronic storage of photos and the fact that film is no longer needed. We also note that stranded assets is a very specific term but is also essentially undefined. This could also imply a ‘brown list’ of activities may exist in the future. We think it is preferable to have a list of economic activities that are considered sustainable for investment purposes and this should be inclusive and not create an exclusion list. Given that the purpose of the legislation is to promote sustainable finance as part of a transition to a low carbon economy, shareholder engagement with carbon intensive businesses is vital in this process. Divestment for fear of stranded asset risk or benchmark risk would likely result in diminishing shareholder pressure on the companies that need it the most. With the right pressure, these large listed companies have the ability to make a significant difference to improving the environment, not only in terms of reducing current global carbon emissions but also having significant capital to invest in renewable energy and sustainability focussed R&D. We strongly urge therefore that regulators are very cautious in their approach and do not introduce a brown list, which may undermine where we may witness the greatest improvements. We would also suggest for consistency purposes that the text in Article 21 ‘where relevant’ should also be replicated in Article 23 to reflect the need for proportionality.

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?

Conflicts of interest are generally in two contexts: conflicts between client and firm and conflicts of interest that could arise between clients. We therefore question the relevance of ESG to conflicts of interest management.

We note, however, that there are conflicts between ESG objectives for example between the objective of energy security and curbing climate change. One could also imagine that conflicts could potentially arise between ESG preferences and investment objectives. There has been significant research done to establish whether sustainable investment impacts risk and returns but it is challenging to be conclusive. As such, it is a complex issue to convey to investors in a way they can make their own informed decision.
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.

We are not opposed to the topic of organisational requirements being included, however, we would suggest no other amendments are needed. The proposed changes are relatively high-level and will enable proportionate application to the investment service and the scale and complexity of the business.

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.

Ruffer does not use labels as such in its investment process. For this purpose when we refer to "Labels" we are speaking in a very broad sense including principles, guidelines and accounting standards (some are audited and some are not).

Within this definition we use the principles of the UN Global Compact (UNGC), the conventions of the International Labour Organisation (ILO) such as "child labour", "excessive overtime, "forced labour", "collective bargaining" or certain standards as developed by the International Organisation for Standardization (ISO) and others.

This is supplemented by our own additional research into ESG factors as well as with research conducted by our ESG research provider MSCI as well as ISS governance research.

It is unclear at this stage, how the taxonomy will be used to lead to an 'overall' rating which can then be relied on for a label. Furthermore, to apply the taxonomy will require comprehensive reporting by the issuer and as a global investor, this will need to encompass all jurisdictions (particularly those outside the EU). It is likely that many investment managers will rely on third party research providers to aggregate data from issuers and synthesize this into metrics that can be applied by investment managers. It is important therefore that such research providers apply the data in a consistent manner.

Nevertheless, we would note it is important that any "common approach" to labels does not purely advocate investing in impactful / 'best in class' environmental, social or governance securities as these may become over-valued. We would also suggest it should not require specific percentages to be invested to result in a label. The reason also being that shareholder engagement needs to be part of the positive ESG toolkit. In this context, we would note that labels can be a positive move to guide in particular retail investors but can also cut diversity and breadth in the fund industry where innovation should be encouraged.
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 understand and support the proposal that manufacturers and distributors should include some information on how the product is sustainable. However, we would urge that the expression of ESG preferences does not lead to a ‘negative market’ but rather, provides an additional information piece. We also note that risk weighting is only one dimension of assessing the ESG dimensions of a share. We have real concerns that many funds invest in third country funds and equities where a target market has not been identified by the manufacturer and therefore this would require distributors to undertake this assessment which could be difficult to do, particularly if information is lacking and this could lead to greater inconsistency.

We also note that that the provision of a segregated mandate is an entirely separate MiFID service, through which investment decisions are made solely at the discretion of the manager, based on the individual terms of an agreed investment mandate.

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 agree with the proposed changes and the addition of a case study. However, as indicated in question 6, we stress that not meeting an ESG preference should not lead to the product being in a negative market, but rather should be considered as ‘neutral’.

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

It is clear from the ESMA proposals that ESG considerations are not a relevant factor in the definition of the ‘negative target market’ and that it is acceptable to hold a product that does not have ESG characteristics in a portfolio for a client with ESG preferences. However, the first bullet point that follows paragraph 15 adds uncertainty to this by asking for further stakeholder guidance. We think it is critical that an investor with ESG preferences can buy a product which is not necessarily ‘ESG labelled’ as part of a balanced portfolio as indicated in question 6 and 7. We also note that the ESG composition of the fund would need to be assessed quarterly or at least every 6 months to avoid ‘gaming’ the assessment of a fund. This is particularly critical with funds as distributors do not know the exact fund holdings to ‘re-assess’ their ESG composition.

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.

We are commenting on how this would apply to a fund or portfolio (rather than a security).
In this case E, S and G factors can be reported separately, to flag to investors where a fund has a specific focus. However, we would suggest that it may be helpful to investors to have a single aggregate rating as well. One approach might be for the manufacturer to take the weighted average of each security's overall ESG rating to provide an overall rating for a fund. It is likely that most manufacturers will utilise research providers for security ratings and therefore access to consistent and comprehensive data will be crucial to deliver this. It would be useful to have a framework and guidance to work with to ensure consistency across the industry. There are risks with this approach. It would be difficult to do if you are a distributor of a third country fund as we would not necessarily have sufficient data on the holdings to do this in the place of the manufacturer. To exclude third country funds as a result could potentially lead to unbalanced portfolios and increase risk for the client.

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.

As an ‘absolute return’ investment manager operating without the constraints of benchmarks we are currently not using any labels or indices to describe or track our products. We are strongly in favour of describing our investment process including how we are integrating Environmental, Social and Governance considerations into the process.

Current labels can be open to interpretation. Taking the target market case study on page 19 for example, the fund has the ‘climate change mitigation’ label applied to it. This label could easily be used to describe a fund that invests in renewable infrastructure (e.g. an investment trust which owns a series of solar farms) or shares in a wind turbine manufacturer. Another fund with the same objective might buy shares in a major oil company. Is the latter “misrepresentative”? At ‘face-value’ it might seem that way by comparison, but if the fund manager was aiming to be impactful through shareholder engagement, the impact might be more significant if it results in the oil company reducing carbon emissions and catalyses a far larger sum of money invested into renewable energy as a result of their engagement and the return greater for the investor as a result of the companies improvements. As such, whilst a common approach and taxonomy is welcomed, we need to ensure it is not overly restrictive in how the labels are applied.

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?

The amendments to paragraph 28 of the suitability guidelines need to be kept at a high-level so that firms can incorporate ESG considerations into their suitability assessment in different ways.

The proposed revision to paragraph 28 suggests “the information collected on ESG preferences should be granular enough to allow the firm to assess the suitability of the investment.” We note that the use of the word ‘granular’ goes above and beyond the current MiFID requirements and
even ESMA’s current suitability guidance. We would strongly prefer that the amendment refer to ‘necessary information’ as is the case at present.

Our strong preference would be to explain how we integrate ESG into our research and assessment of investments and then discuss with the client if this suits the clients desires (given we are discretionary managers and carry out significant ESG analysis – even if we do not label our funds or investments as particularly ESG-driven). Whilst at present we do exclude certain types of investment for clients who express an explicit requirement to do so. This is facilitated through negative screening and can be done on specific companies or indeed sectors.

We would not support the “simplified approach” advocated in paragraph 12. This approach, whereby a client can dictate a set percentage of the portfolio they wish to have in ESG investments could act against the best interests of the client and conflict with other aspects of the suitability assessment (such as their financial experience and risk profile). Given the limited application of ESG to fixed income, especially at a sovereign level, a percentage-based approach is likely to distort the asset allocation unintentionally, resulting in a higher weighting to riskier assets such as equities. It would also work against an engagement approach for example, encouraging high emitting companies to reduce their emissions.

Ruffer would also welcome a more concrete differentiation between ESG preferences and considerations. We currently understand that the latter refers in principle to the underlying process of integrating ESG into the investment process and the former to specific products in relation to ‘E’ and ‘S’ and ‘G’. It would be interesting to understand how segregated mandates fit into this description.

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.

Firms will need to explain how they integrate ESG into their processes and ask the client what factors they are particularly interested in and have a preference to invest in, if appropriate.

At Ruffer, ESG issues are considered alongside other factors in the company research undertaken by Ruffer’s analysts.

We use MSCI ESG Research and other relevant sources to incorporate systematically ESG considerations into our investment process. For example:

- ESG issues are discussed when stocks ideas are proposed
- ESG considerations are included in the on-going stock review process
- ESG macro issues and implications of megatrends such as climate change, water scarcity and the energy transition are discussed regularly

This investment approach applies to the vast majority of equities under management.
Additionally, we service a number of clients who have their own ESG constraints and considerations (often outlined in their Investment Policy Statement) that they require expressing in their portfolio.

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

No answer

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 anticipate that these changes could be quite significant. Much is dependent on how ESMA requires the suitability process to be adapted to integrate ESG. If it is undertaken in a highly prescriptive approach, we anticipate it would require a very significant adaptation of our IT systems to manage these preferences. There would also need to be significant IT changes for reporting and monitoring purposes. These would be one-off costs. However, we would also anticipate significant ongoing additional staff-costs particularly associated with a more onerous suitability requirement.

Data to undertake ESG analysis is costly, and we would anticipate research costs to go up considerably. This will be particularly burdensome for global investors who will require very broad coverage. These would be increased ongoing costs.

Should you wish to have further information or clarifications on our response, please do not hesitate to get in touch with me.

Victoria Powell
Regulatory Policy Director