afme/
Finance for Europe

Association for Financial Markets in Europe

AFME response to ESMA Consultation Paper on integrating sustainability risks and factors in MiFID II

19 February 2019

AFME and its members welcome the opportunity to respond to ESMA Consultation Paper ("CP") on integrating sustainability risks and factors in MiFID II legislation. In our response we provide our general comments as well as answers to the specific questions raised in the CP. We would be pleased, of course, to discuss the content of this document to provide any further clarity with regards to the statements made.

GENERAL COMMENTS

AFME generally welcomes the high-level principles-based approach suggested by ESMA across the CP but highlights that it is important that ESMA's proposals should not exceed steps necessary to achieve the Commissions targets outlined in its Commission action plan on financing sustainable growth[1]. Our members are not in favour of narrow and prescriptive requirements because sustainable finance initiatives are still evolving, there are multiple frameworks and industry practices in the market, that have different strengths and weaknesses, being suited to different sets of preferences and circumstances. Meeting strict and prescriptive requirements on how sustainability/ESG risks and factors should be integrated into MiFID II would be challenging and is likely to restrict innovation in this growing area. Given that many definitions still need to be clarified, consistent with our response to the Commission's amendments to the delegated act supplementing MiFID II on suitability requirements[2], we strongly believe that the ESG considerations should ideally be included in MiFID II legislation after the EU Taxonomy as well as the concepts of sustainability risks, ESG risks, other ESG considerations and sustainable investment have been defined by policymakers. This would help reduce legal uncertainty potentially arising from the legal and regulatory frameworks that are still evolving. Were the updated MiFID II legislation to come into effect before clear definitions are implemented, the changes in the legislation should not attempt to pre- or re-define ESG-related concepts but should allow firms flexibility in establishing the respective frameworks and internal policies defining the ESG principles and related concepts.

We also believe that the definition of ESG principles for the purpose of MiFID II needs to be broader than the Taxonomy. While the Taxonomy aims to define a list of sustainable economic activities that can be easily linked to a product standard, ESG factors should provide a framework for investment analysis that allows the capture of a broader and more nuanced set of client preferences around sustainability and responsible business practices.

If the definition of ESG principles were to be exclusively tied to the Taxonomy, it would most likely hinder the development of the market for sustainable investing by focusing on a limited range of "pure" products (e.g. labelled "green" or otherwise "sustainable") instead of facilitating a larger scale transition of companies and organisations towards more responsible business models and subsequent product/service offerings. Therefore, there must be a clear distinction between economic activities that comply with the Taxonomy and ESG considerations, especially given the fact that it would still take considerable time for the Taxonomy to be finalised and that, at least initially, it will not cover social and governance issues as was also noted by ESMA in

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

[2] https://www.afme.eu/globalassets/downloads/consultation-responses/afme-mfd-response-to-the-commissions-amendments-to-the-delegated-act-supplementing-mifidii.pdf

the CP. In particular, it should be clarified that the EU Taxonomy does not constitute an exhaustive and exclusive classification system for sustainable investment, meaning:

- environmentally, and later socially and/or governance friendly activities might not necessarily be included in the list of the EU Taxonomy-compliant activities; ESG considerations for MiFID II regulation purposes should also take into account existing corporate practices (i.e. application of "ESG filters", best-in-class or best-in-universe strategies, exclusions, thematic funds, impact investments, etc.) in promoting sustainability which might not exactly coincide with the EU Taxonomy.

- even if environmentally, and later socially and/or governance friendly sustainable investments may have to finance a certain percentage of the EU Taxonomy compliant activity, they may also finance ESG friendly activities, which are not necessarily compliant with the EU Taxonomy but that are rather based on existing corporate practices. These practices can then be disclosed by entities to explain their approaches to ESG (i.e. internal policy frameworks, internal governance and control functions, etc.).

To avoid duplicating implementation effort and costs, it would be preferable if regulatory changes in this field were sequenced so that the Taxonomy is finalised before the changes to the MiFID II requirements are effective: in this way firms could take a holistic view of the changes required and implement them together.

Additionally, it is crucial that embedding ESG risks and factors into capital markets should be done in a progressive and sequential way, first by recognising the existence of actual practices in relation to the integration of ESG risk factors applied by financial advisors, asset managers and institutional investors, and then by clarifying regulator's expectations vis-à-vis players. We also believe it is important to integrate ESG concerns in MiFID II without attributing a disproportionate importance to ESG factors vis-à-vis other factors and risks (liquidity, credit, market).

Finally, but very importantly, the new regulation should assign clear responsibilities to each market participant. The responsibility of the entities as investment advisors should be clarified. The obligations for these entities should be limited to including products with ESG "label" in their offer and in the portfolios of the interested clients, but in any case, should not include the verification of the ESG criteria in the underlying companies or products. The firms would not be in a position to make such verifications and any liability should rest with the issuer of the relevant financial instruments.

RESPONSES TO SPECIFIC 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.

We are supportive of an integration of ESG considerations in organisational requirements, when this is relevant, and we agree that a high-level principles-based approach would be best suited for this purpose. However, while the additional wording suggested for Article 21 allows for a principles-based approach, it is unclear why it is necessary to highlight ESG factors specifically in the context of an article that covers the overall firm organisational requirements. The proposed changes in Article 21(1) "*Where ESG considerations are relevant for the provision of investment services to clients, firms should take them into account when complying with the above requirements*" lack clarity in that they do not specify the scope of investment services they apply to. To reach the main goals of the Commission action plan on financing sustainable growth we understand that the only investment services that must consider ESG factors are portfolio management services and advisory activity. As such, we believe the changes would exceed the mandate received by ESMA from the Commission. Also, it is unclear how other investment services (e.g. reception and transmission of orders, execution, operating an MTF) should be treated in the context of ESG considerations. We therefore do not support the proposed changes to Article 21(1), which would affect the totality of a firm's activities and recommend instead that the changes be introduced in the relevant articles covering the specific services.

We agree that it is important for the firms to ensure that "staff involved in the advisory process possess skills, knowledge and expertise for the assessment of sustainability risks". We note, however, that different sized firms and different business models will influence how firms determine the allocation of necessary people, skills and knowledge. We do not believe that it would be necessary or indeed efficient for the regulator to specify how firms should resource themselves to comply with the skills and knowledge requirement (such as sustainability experts placed within functions and businesses beyond Risk and Compliance). On a related matter, we do not believe that individual senior managers should be responsible for sustainability risk (i.e. having a sustainability expert accountable for all parts of a business). Rather, sustainability risk should be integrated with other risks into the responsibilities that each senior manager has for their particular business or function.

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.

AFME agrees with ESMA's view stated in Paragraph 8 of the Risk Management section of the CP that "*singling out sustainability risks (amongst the various risks that are relevant for firms) is unnecessary to achieve the Commission's objectives and would be disproportionate*". We also believe that this principle should apply to approaches to governance and processes, in line with the current MiFID approach. Sustainability risks should be treated in the same way as other risks, such as market risk, and not as a special category.

AFME also agrees with the points noted in Paragraph 9 stating that "*While the Commission is developing the taxonomy, investment firms shall take a broad approach to assessing potential sustainability risks. Considering the high search costs that are currently attached to sourcing reliable and useful sustainability related information, the approach shall be proportionate to the relevance of these risks for each firm, based on the type and complexity of their activities*". We are supportive of ESMA's view that integrating sustainability risks into suitability assessments means that firms should consider the potential for sustainability risks to impact the financial return of an investment. Specifically, we believe that the requirement should apply to the risk that a sustainability factor might cause the investor to incur economic losses.

Additionally, when assessing to which extent sustainability factors impact an underlying borrower/issuer's credit, market, operational or reputational risks, the risk management functions may consider the extent to which the borrower/issuer has planned its transition to a more sustainable model on the medium to long term basis. For example, at the moment there are borrowers/issuers which are significantly exposed to certain sustainability vulnerabilities, such as climate change. In our view, the risk evaluation process should reflect medium to long term strategies of the borrower/issuer in enhancing sustainability.

Finally, it is important to note that firms might not be able to take account of the impact of sustainability risks on broader society and the economy. We believe that it would be practically difficult to assess these broader implications at the moment. Additionally, doing so could lead to reduction of investor choice because a much wider range of risks would need to be considered before passing a suitability assessment.

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 that firms should have a conflicts of interest policy that, amongst others, includes sustainability risks. However, in line with the answers to Question 1 and Question 2, we do not think it is necessary to include a new recital to specifically cover ESG considerations when considering conflicts of interest. Conflicts of interest are already regulated in a general manner under MiFID, where ESG factors would be included too. Developing a new provision specifically for ESG factors would imply giving them more prominence than to other equally relevant criteria.

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 do not believe that other amendments would be required.

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.

Paragraph 8 on page 14, Paragraph 7 on page 22 and the amended ESMA Guidelines on certain aspects of the MiFID II suitability requirements of the CP refer to "*current market standards*". The reference is made in a way that implies there is a common and uniform market in third party (vendor) ESG ratings. We would like to note that various research and analysis highlights differences in the quality of the data, their methodology and, in some instances, inconsistencies between the ratings that companies are given.

For this reason, we urge ESMA to recognise that the landscape of ratings and advisors is evolving, and so are the ways in which sustainability factors are incorporated into the investment process. A firm's approach to ESG will be delivered using external data and research, with proprietary analysis and research to inform end decision making; each firm will choose the inputs and the process which it believes are most appropriate to the clients and services that it offers. Firms' proprietary frameworks allow the assessment of the sustainability of investments (especially of single stocks, bonds and collective investments) and the determination of ESG characteristics (also as part of the distributor target market). Proprietary frameworks usually elaborate relevant raw data such as the UN Sustainable Development Goals, as well as data from leading ESG rating agencies. Some firms will be members of organisations such as UN PRI (Principles for Responsible Investing) with the aim to support the consideration of ESG factors across their business and within the industry.

In future, as market practice evolves, ESMA may wish to provide guidance on what good practice looks like, bearing in mind that firms may have taken different paths for legitimate reasons and taking into consideration that requiring additional changes to their systems, controls and processes for compliance will impose additional costs, which may, to some extent, be borne by investors through the costs of the services purchased.

With respect to "labels" used, we note that green bonds are a product area where third-party labelling seems to be more commonly used by product issuers and investors. Commonly accepted labels are those of the Climate Bonds Initiative and the Green Bond Principles.

AFME generally supports the creation of European labels, through the Ecolabel but also through the ESG label. We believe labels can play a role, but only as one tool of the many tools at the disposal of investors and their advisers. We also note that labels can be used by investors to promote one type of investment philosophy. Therefore, we think labels should not serve as an absolute benchmark for investors as this may lead to a reduction in choice of products for customers. Also, we note, as evidenced by the labels provided in the CP, that labels tend to be national in focus. There is a concern that national labels might create barriers to entry in different local markets by setting different standards across different countries. Additionally, the combined cost of national labelling and promotion of the labels adds transaction costs, which could be reduced if labels are developed and operationalised at the European level.

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 that the target market is the best tool to indicate the ESG nature of a financial product and that the ESG preferences should continue being embedded in the "client's objectives and needs" category rather than being referenced into a sixth criterion.

However, in our view, the new text seems to suggest three major implications:

- a new KYC process that includes a detailed screening of clients' "interests",
- a new product governance including ESG assessment for all financial instruments provided to clients,
- a link between the two above, and ongoing monitoring.

AFME notes that this is intended to accelerate ESG integration. While this is the direction that many financial institutions are envisioning, a regulatory requirement would always necessitate adjustment and in many cases changes would be substantial, so it is key that, sufficient time would be allowed for the organic and smooth transition. This would be advantageous for investors (who will need to understand the new framework and answer questionnaires to provide views), providers (who will need to label their offerings) and intermediaries (who will need to make changes to their systems and train staff).

We note that other "characteristics and objectives" are not detailed in the Delegated Directive (i.e., preservation of capital, leveraged, recommended holding period, etc.) and we appreciate the flexibility thus provided. This should also be also the case for ESG preferences.
We believe that it would be necessary to specify the scope of ESG considerations with regards to product governance, since ESG would not be relevant to all types of products. We would therefore recommend adding "where relevant" to the proposed amendments and clarifying this point in ESMA's final technical advice.

The assessment of the target market and the compatibility of a financial product with or without ESG characteristics must be done in relation to all five categories provided for in MiFID II for the determination of the target market and then in relation to the consideration of the ESG factors that intervene as a sub-criterion of the category "Objectives and needs". It thus should be clear that a product without ESG characteristics may be offered to customers who expressed ESG preferences, if it meets their preferences under the other categories.

AFME notes that the current Guidelines on MiFID II product governance requirements establish that "*Firms that distribute products that have not been manufactured by entities subject to the MiFID II product governance requirements are expected to perform the necessary due diligence so as to provide an appropriate level of service and security to their clients compared to a situation where the product had been designed in accordance with the*

MiFID II product governance requirements". In this regard, we reiterate that the definition of ESG is not clear, therefore, the due diligence performed by distributors might have certain limitations. It is essential that the regulation clarifies that the responsibility to determine if a financial instrument meets the ESG criteria should rest with the issuer.

An explicit reference to ESG preferences raises a question of how to fulfil this in the "European Market Template" (EMT) document which includes the target market. Clarification would be welcome as to whether the explicit reference to ESG would mean that a new additional column will have to be included in the EMT (where the Target Market is described) in order to reflect if the product takes into account these factors.

Finally, we would like to emphasise that integrating sustainability considerations into the product governance regime is only possible when sufficient and reliable underlying issuers' ESG data is available. We note that there is still lack of available, reliable ESG data on issuers' activities and/or behaviours, though it is expected to evolve with further improvements in corporate reporting standards.

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.

Please refer to our response to Question 6.

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

Considering there is no full consensus on a taxonomy yet, it would be easier to keep the definition of both target markets ESG client preferences and ESG product characteristics at high level.

Additionally, it would be important to consider the difference between ESG aspects of an investment solution, and the ESG "Rating". If the aim is to promote "considering" ESG aspects, then it should include both solutions that concentrate on investments in companies that are already ESG leaders, and investments in companies that are not yet, but invest in improvements.

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.

AFME notes that firms will need to define how the message about the new requirements will be delivered to customers. In this regard, we are in favour of flexibility, in order to avoid any potential negative target market or other unintended restrictions. As noted previously, it is important that clients should be able to choose and/or accept products which do not include ESG factors. Therefore, we expect that no negative target market is considered if a product does not have ESG characteristics while the client has certain ESG preferences.

Considering the variety of existing practices across the industry, it would be necessary to keep those considerations qualitative, at least for the time being.

AFME also suggests that firms should be able to reflect investor preferences as to whether "E", "S" and "G" are identified separately or as a whole as part of product governance or suitability assessment (please see also our response to Question 12). It could be argued that, from a client perspective, the discussion of ESG preferences would likely be most fruitful if the different aspects are treated separately, as different clients will have different views as to the relative importance of ESG variables (for example, a client may have strong views about E issues, and weaker ones about S, while another may hold S priorities in the highest regard but not be so interested in G). Therefore, product information would also need to report on the three aspects separately to allow a better match between product characteristics and client preferences. However, it could also be argued that making a clear distinction between ESG dimensions might not be appropriate for all types of investors or investment vehicles. Some firms do not manufacture products that specifically target "E", "S" or "G" only and many clients do not limit their ESG preferences to one specific dimension. We thus think that there should be a possibility that some products could be linked to a single indicator and deemed ESG compatible if at least one of the three ESG criteria is met.

AFME suggests that the UN SDGs could be a good starting point for collecting clients' preferences on ESG. They are topic oriented and "tangible", which should make it easier for a client to articulate views. It is also possible to group the UN SDGs into different clusters orientated at "E", "S" and "G".

AFME notes that it is important to highlight the following:

- If a product meets certain ESG preferences but a client has no specific preferences it does not mean that the product is unsuitable for the client;

- If a client's ESG preferences differ from a product's ESG targets, reasonable tolerance needs to be allowed as a perfect match on different dimensions seems unlikely. Excessive narrowing of the universe of investment products would not be of benefit for clients.

- Overall, we believe that ESG considerations should only come into play once other suitability criteria have been fulfilled, meaning that they would serve as a final set of considerations rather than narrowing the options earlier on in the process.

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.

Please refer to our response to Question 5.

Additionally, we would like to note that the industry is generally moving from ESG screening to impact investing, therefore transitioning from exclusion strategies to impact measurement.

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 believe the suggested amendments are acceptable if "*EU's classification system of ESG investment product*'" can be understood in its broadest sense, and if it is made clear that this classification system does not coincide with the EU Taxonomy. Directly linking "*EU's classification system of ESG investment products*" to the EU Taxonomy would result in unnecessary and duplicative costs associated with adjustments and recalibrations of already implemented solutions, re-training staff, etc., which should be avoided. In addition, we note that it is important that the suitability guidelines be maintained as good practice and not deemed mandatory.

Consistent with our response to Question 6, we are supportive of a measure that would require a firm to collect information on clients' ESG preferences. However, we agree with ESMA that ESG considerations should be an additional aspect to the other suitability criteria and that therefore a client's ESG preferences should not prevent non-ESG products from being treated as suitable if they otherwise meet the clients' financial objectives and needs.

For example, a client may wish to promote gender diversity in the businesses he/she wants to invest in, but if that conflicts with his/her financial goals and/or investment horizon given the opportunity set available, then that preference should not prevent the client from investing more widely.

We note, however, that the scope of the investment advice provided by a firm may vary and, therefore, ESG considerations may not be relevant for the particular investment advice service that is provided to a client. In this respect, MIFID II recognises that investment firms may establish different approaches to the scope of investment advice they provide and that the advice may be based on a broad or a more restricted analysis of different types of financial instruments. For instance, a firm may provide an investment advice which is addressed specifically to hedging the interest rate risk arising from the financial positions of clients. In this case, ESG considerations would not be relevant for the scope of the advice and, therefore, information on the client's ESG preferences would not be part of the suitability assessment. In this respect. we would like to reiterate the importance to provide investment firms with flexibility to identify the best approach to incorporate ESG considerations into suitability assessment.

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.

Consistent with our response to Question 9, we consider that there should be a choice of whether ESG criteria can be assessed separately or as a whole at due diligence level. Depending on the investment type, sector, region, instrument, one of those criteria may be more relevant than the others in the overall evaluation/exclusion/inclusion. Therefore, there are cases where we do not consider that a single ESG indicator would do justice to the variety of client preferences and beliefs and could result in unsuitable matches. However, we note that in other cases a single ESG indicator would be sufficient and would still meet client's needs.
We think that this is an area where it is important that the adviser can make an overall judgment based on their knowledge of client preferences and product characteristics.

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

AFME agrees with the suggested approach, however, it should be noted that at the moment, most firms include ESG considerations in their procedures for some products, but by no means all. The change proposed, while theoretically acceptable, needs to be introduced gradually as it would require a complex, likely multi-year project to be implemented.

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.

AFME believes that all of the mentioned costs would be relevant and should be considered. As stated above, whilst most firms include ESG considerations in their procedures for some products, this is not applied for the entire range of products and services. The changes proposed would need to be introduced gradually as noted above. Such changes would for instance include, but would not be limited to:

- Integrating ESG considerations into research (from macroeconomics to sectors and single securities), including building people's competences;
- Integrating ESG considerations into model assumptions;
- Integrating ESG data into portfolio management systems, risk management systems and suitability assessment processes;
- Integrating ESG considerations into the securities selection processes and collective investments due diligence;
- Integrating ESG considerations into reporting systems;
- Training all employees on ESG;
- Other ongoing costs related to IT systems to monitor risks and include the new methodology that would be established.

AFME Contacts

Tonia Plakhotniuk, Manager, Policy

Tonia.Plakhotniuk@afme.eu

+44 (0)20 3828 2717

Cedric Pacheco, Manager, Capital Markets

Cedric.Pacheco@afme.eu

+44 (0)7825 346 493

About AFME:

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.