Dear Sir/Madam,

Response to ESMA Consultation Paper on Integrating Sustainability Risks and Factors in the UCITS Directive and AIFMD

The Alternative Investment Management Association (AIMA)\(^1\) welcomes the chance to respond to the European Securities and Markets Agency’s (ESMA’s) public consultation on integrating sustainability risks and factors in the UCITS Directive and AIFMD.

Sustainable finance and responsible investment are increasingly important issues for the alternative investment management industry. Recent AIMA research\(^2\) indicated that roughly half of the alternative investment managers surveyed had experienced an increase in investor questions about responsible investment over the preceding year.

Our members welcome this development, and agree that investors should have the option to invest their capital in sustainable finance products. Some alternative investment managers are already offering such products to their investors. Alternative investment managers also recognise that sustainability risks can jeopardise the value of their investments, and are responding by adapting their investment decision-making and risk controls.

We would, however, highlight that there are still several issues that must be considered when contemplating the integration of sustainable finance in the alternative investment management space. First, there is the fact that many alternative investment managers have investment strategies for which sustainability factors have little to no relevance. For example, such factors are difficult to apply to strategies focused on interest rate derivatives, or on EU sovereign bonds.

\(^1\) AIMA is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA’s fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) - the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA’s website, www.aima.org.

Second, sustainable finance remains a nascent phenomenon. Even the terminology surrounding the issue is unsettled: socially responsible investment, responsible investment, and sustainable finance are often used interchangeably. ‘Sustainable investment’ alone is a broad term. For some investors it may mean the exclusion of certain securities based on moral beliefs; for other investors it may mean weighting a portfolio based on environmental, social and/or governance (ESG) factors.

Third, the data necessary for the rigorous implementation of sustainable finance is often expensive, inconsistent, or simply unavailable. At present, issuers are not required by regulation to disclose most ESG data. Data provided by third parties, meanwhile, is often inconsistent: the same issuer can be given wildly different sustainability ratings by different data providers. In the case of private assets—those assets not traded on public markets—data may simply be unavailable. As such, alternative investment managers are often hard-pressed to acquire the data necessary to properly implement sustainable finance.

All these challenges can be overcome. However, such a significant change in investment management will take time. Alternative investment managers must have the flexibility to find the most effective ways of implementing sustainable finance; the necessary markets and exchanges must be able to grow naturally.

As such, ESMA is right to suggest high-level, principles-based amendments to the current regulatory regime. By keeping regulation at a high level ESMA can avoid stifling innovation in this dynamic field. Further, by avoiding highly prescriptive requirements ESMA can ensure that sustainable finance takes root in a natural, sustainable way, and becomes a meaningful component of investment management.

We believe that sustainable finance is a laudable initiative, and we present our comments in that spirit. Our comments are meant to help ensure that the proposed regulation attains its objectives as effectively as possible, and that investor interests are always put first.

If you have any questions or would like to discuss any aspect of this issue in more detail, please contact Jirí Król (jkrol@aima.org) or Max Budra (mbudra@aima.org).

Yours sincerely,

Jirí Król
Deputy CEO
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Annex: Response to Individual Questions

Q1: How do you understand or how would you define the notion of "sustainability risks" for the purposes of the delegated acts adopted under the UCITS Directive and AIFMD?

We feel that the definition of ‘sustainability risks’ provided by ESMA in its analysis is too broad to effectively protect investor capital. As currently written, there is no materiality threshold when it comes to the concept of sustainability risk, nor any stipulation regarding its immediacy.

Theoretically, every investment is exposed to sustainability risks: catastrophic climate change, for instance, would affect the entire financial system. To take a less extreme case, a hurricane in the Gulf of Mexico could increase the cost of refined oil, leading to a decline in factory output in Shenzhen, and thus a slight fluctuation in the value of the renminbi. Under the definition of sustainability risk provided by ESMA, an alternative investment manager with any capital invested in the renminbi may need to account for the sustainability risk of hurricanes in the Gulf of Mexico.

Given the interconnectedness of the global financial system such a situation could degenerate to a point where ‘sustainability risk’ has no practical meaning. This could undercut the protection of investor capital from “climate change, resource depletion, environmental degradation and social issues,” as it could be unclear to investors which sustainability risks are probable and which merely possible. We recommend clarifying that sustainability risks must be both material and directly relevant (i.e. the risk would affect the security in question directly).

As such, we would favour an interpretation of ‘sustainability risk’ along the following lines: “a material risk that an investment will incur volatility or an absolute loss of value due to direct environmental, social, or governance causes.”

Further, it is important to remember that the concept of ‘sustainability risks’ is being addressed in other pieces of legislation that are currently subject to the co-decision procedure, including the Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341. It is crucial that the definitions adopted across the various texts are aligned to avoid any interpretative challenges or legal conflicts.

Q2: Do you agree with the proposed amendments relating to organisational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

We welcome the high-level nature of ESMA’s proposed amendments. However, to be effective the regulatory requirements relating to sustainability risks must recognise the varying degree of materiality of such risks to the activities of an investment manager. As currently written the proposed amendments affect every investment manager, without differentiating between managers for which sustainable finance is not material. Through our interactions with members it has become clear that sustainability risks, and sustainable finance more generally, are simply not material for many...
alternative investment managers. A strategy focused on short-term sovereign bonds from developed countries, for instance, is unlikely to court sustainability risks. Further, many alternative investment managers hold assets for periods of time that are short enough to make the manifestation of sustainability risks highly unlikely: some market makers, for example, hold assets for only a few hours.

Requiring firms to take account of sustainability risks without regard to their materiality could ultimately lead to increased level of so-called ‘greenwashing,’ in which industry participants declare themselves to be engaged in sustainable finance after doing the bare minimum to qualify.

As such we recommend that the proposed amendments adopt a proportional approach, and recognise that sustainability risks are not material for all investment managers. This would maximise the impact of the proposed amendments, and help ensure that sustainable finance retained its meaning (and that investors could be assured that firms engaged in sustainable finance were engaged in a meaningful manner). We would recommend changing the proposed amendments to the responsibilities of senior managers in AIFMD and the UCITS Directive thusly: “(g) is responsible for the integration of sustainability risks and factors if material to the investment activities of the firm.”

Q3: Do you see merit in expressly requiring or elaborating on the designation of a qualified person within the authorised entity responsible for the integration of sustainability risks and factors (e.g. under Article 5 of the Commission Directive 2010/43/EU and Article 22 of the Commission Delegated Regulation (EU) 231/2013)?

We recognise the rationale behind this proposal, but at present we do not believe such an arrangement would further the stated goals of the proposed amendments.

Setting aside the question of materiality (see our response to Question 2), we believe that the existing regulatory requirements around a designated person responsible for risk management can already accommodate sustainability risks; an additional designation would be redundant. Further, designating a specific person responsible for such integration, and differentiating that responsibility from responsibility for overall risk, could create a scenario in which sustainability risks are permanently excluded from traditional risk management. In other words, any such regulation could reify a distinction between ‘traditional’ risk management and sustainability risk management.

The designation of a specific person within an authorised entity responsible for the integration of sustainability risks and factors may therefore undercut the objective of integrating sustainability risks and factors into the traditional investment process.

Q4: Would you propose any other amendments to the provisions on organisational requirements in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

We have no other proposed amendments at this time.

Q5: Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? If not, please elaborate
on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

We agree with the principles-based approach taken by ESMA, for reasons explained above. We would also highlight a potential issue with the proposed amendment to Article 23 of the UCITS Directive. As written, the proposed amendment would require authorised firms to integrate sustainability risks and factors in their due diligence, the analysis involved in which must “only be carried out on the basis of reliable and up-to-date information, both in quantitative and qualitative terms.” The use of accurate data is, of course, integral to the due diligence process. However, data on sustainability risks is currently extremely scarce, and of varying quality. As ESMA has noted, issuers are under no regulatory obligation to publish data on most ESG factors; third-party data are often inconsistent. As such, obtaining useful ESG data can be highly expensive for investment managers, a reality also acknowledged by ESMA.

Further, by requiring all investment managers to use such data the proposed amendments run the risk of creating an artificial market, in which investment managers are forced buyers and data providers lose their market incentive to generate the best possible data. We feel that this would likely undercut the goals of the proposed amendments, as it would ultimately detract from the broader effort to foster sustainable finance, and harm the goal of “foster[ing] transparency […] in financial and economic activity.”

As such, we believe it is important to clarify that investment managers (for which sustainability risks are material) should only be required to take reasonable steps to integrate sustainability risks in their due diligence. Given the complexity of the issue, investment managers are best placed to determine the kind of data they need to judge sustainability risks, and whether they can actually acquire such data. Any regulatory requirement to use ESG data should only be contemplated once a regulatory regime guaranteeing both the existence and the quality of such data is in place.

Finally, we would not favour a more granular approach to the proposed amendments, as we believe due diligence is intrinsically linked to the investment process. Should ESMA decide to adopt more prescriptive requirements on due diligence this will ultimately affect the investment process to the detriment of the competitiveness of the investment manager—the core selling point of which is its investment strategy.

Q6: Do you see merit in further elaborating in the provisions above on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments?

We believe that ESMA was correct to choose a high-level approach to the proposed amendments. As stated above, the dynamism of this issue lends itself to principles-based regulation; we believe a more granular approach could be counterproductive. Research on the effects of sustainability factors and indicators on financial performance is still inconclusive. Further, we believe that alternative investment managers are best placed to judge which sustainability factors—if any—are relevant to the financial performance of their investments. The goals of the proposed amendments could best be accomplished by providing space for investment managers to experiment and discover the best ways of integrating sustainability factors in the investment process.
Q8: Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

We believe that a high-level, principles-based approach to any regulation in this field is preferable, for reasons stated above.

Q9: Do you agree with the proposed amendments to provisions relating to the risk management included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

We welcome ESMA’s high-level approach, for reasons stated above. We believe that the proposed amendments are reasonable.

Q10: Do you see merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks (e.g. techniques, tools and arrangements enabling the assessment of sustainability risks, probability of occurrence and time horizon of sustainability risks with regard to the expected time of holding of the positions bearing the risks, quality of underlying data and methodologies etc.)?

A high-level approach is the most effective way of accomplishing the stated goals of the proposed amendments. As ESMA recognises in its analysis, “the methodologies used to monitor sustainability risks are often fairly new.” Accurately measuring sustainability risks is exceptionally difficult, and investment managers need the freedom to experiment in order to find the most effective ways of doing so.

There are two reasons for this difficulty. First, there is the scarcity of quality ESG data, discussed in our response to Question 5. Second, sustainability risks are by nature infrequent phenomena. As such, there is an exceptionally limited sample size of such events from which investment managers can extrapolate. Indeed, for some sustainability risks, such as stranded assets occasioned by an abandonment of fossil fuels, there are no modern precedents.

As such it is imperative for ESMA to avoid a highly prescriptive approach to the proposed amendments. In order to be effective investment managers need the flexibility to test what kinds of risk modelling work in this sphere, and the discretion to choose the most useful data.

Q11: Do you see merit in amending risk management provisions relating to regular review of risk management policies and systems in order to more specifically refer to elements related to sustainability risks (e.g. quality of the arrangements, processes, techniques and data used, need for authorised entities to highlight the limitations, and demonstrate the absence of available alternatives)?
The regular review of risk management provisions relating to sustainability risks is, of course, deeply important in such a dynamic field. However, investment managers are best placed to know what to include in any review of such arrangements. Further, we believe that the language around the review of risk management in existing regulation could already encompass sustainability risks; as such any additional language may be redundant.

Q12: Would you propose any other amendment to the provisions on risk management in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risk and factors?

For the reasons stated above, a high-level approach to any regulation touching on sustainable finance is preferable.