CONSULTATION RESPONSE

ESMA CONSULTATION PAPER ON TECHNICAL ADVICE ON THE INTEGRATION OF SUSTAINABILITY RISKS AND FACTORS IN THE DELEGATED ACTS UNDER MIFID II

Mirova

Investing in sustainability

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INTRODUCTION

ABOUT MIROVA

Mirova is an investment manager dedicated to sustainable investment and an affiliate of Natixis Investment Managers. Through a conviction-driven investment approach, Mirova's goal is to combine value creation over the long term with sustainable development. Mirova's talents have been pioneers in many areas of sustainable finance. Their ambition is to keep innovating to propose the best tailored and most impactful solutions to their clients.

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SUMMARY OF RESPONSE

Mirova strongly supports the willingness of the EU Commission to better integrate sustainability in products governance and especially when taking into account of investors' sustainability preferences. Mirova pushed in favor of these evolutions through the contribution of its CEO Philippe Zaouati to the High Level Expert Group on Sustainable Finance (HLEG).

With regards to investors' preferences, given the complexity of stakes, we favor a simple approach based on high-level and principle-based questions to end-investors. We also would be volunteer to help test the usability of sustainability preferences questionnaires for end-investors and for investment managers and intermediaries.

The definition of clear European markets standards and labels, such as the upcoming EU ecolabel, is key in this regard since it will enable to bring concrete and ambitious answers to clients seeking to invest sustainably, while keeping it manageable for investment managers through the definition of common and clear guidelines.

With regards to the integration of sustainability risks and factors in the MIFID regulation, this is as noted by ESMA, very complex since the definition of ESG and sustainability is not explicit in the current EU regulation. The integration of these concepts in the regulation may create a lot of confusion if not well defined. Based on our experience as a pioneer of sustainable investment, we would encourage ESMA and the EU Commission to make clearer distinction between two concepts that should both be taken into account:

- **On the one hand, ESG risks** that may affect the value of portfolio; this may result from a combination of environmental, social and governance factors, materializing some physical, liability or reputational risks in the long-term valuation of investee assets. This should be part of the fiduciary duty of all investors to take them into account, as suggested by the PRI (see PRI's answers to the ESMA consultations). This could be also implemented through the definition of minimum ESG standards, as suggested by the HLEG.
- **On the other hand, Sustainability (positive) impact investments objectives** that may be the purpose of the investment strategy (in line with the idea of an EU taxonomy of sustainable activities) and that may be part of the client's sustainability preferences. In

this regard, we consider that this may concern only environmental (E) and social (S) issues, since there are no funds investing directly into economic activities that positively contribute to sustainability on a governance aspect: governance may be a means to bring a positive sustainable impact but is not as such a sustainability preference.

The two concepts shall therefore be differentiated and taken into account in the framework of the MIFID revision. For more clarity, we suggest to replace “sustainability risks and factor” by “ESG risks and sustainability investment objectives”.

RESPONSE TO DETAILED QUESTIONS

2. Organisational requirements

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 overall agree with the idea to amend Article 21 of MIFID II, however we fear that the current drafting may cancel the impact of the sentence: introducing the mention "where ESG considerations are relevant" may excessively limit the impact of the suggested change, especially when there is no additional specification on when ESG considerations are relevant and when they are not. This leaves it to the choice of investment firms to comply or not with this requirement. Cases where ESMA would deem ESG considerations as non-relevant for the provision of investment services should therefore be precisely defined in order not to leave the interpretation to market players alone. If a better definition was not possible, we suggest to integrate a "comply or explain" clause.

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 risks management function shall ensure that ESG risks are taken into account in investment processes, however it should not define the tolerated risk level but shall validate the investment process. So far, this means to validate the limits for credit risk market risk counterparty risk and liquidity risk on the basis of a proposal from the investment teams. Tomorrow it could also mean to validate the ESG risk level on the basis of the investment team proposal.

We would like to raise one aspect of ESMA's analysis on risk management (page 9 of the consultation paper), which discusses the development of the unified classification system, or taxonomy. We recognises that the taxonomy will be a critical tool for investors and issuers. However, if developed as per the draft regulation, it will assess the contribution that activity seeks to make to environmental objectives but make no judgement on the riskiness of that investment. We therefore see it as a policy tool to drive capital towards sustainable outcomes, rather than a tool for integration of ESG risks into investment processes.

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?

It seems to us that the notion of what could be a conflict of interest that might arise in relation to sustainability considerations is not sufficiently defined and well understood to integrate the recital as such. The wording in terms of "conflict of interest" seems confusing given the examples provided in ESMA's analysis.

In addition, the examples provided by ESMA in the analysis section do not always seem relevant. For instance: an ESG product may have a different cost if it requires more research and technological / human resources, and this would not correspond to a misselling practice.

In our view, the main source of misselling practices associated with ESG products to date is due to the lack of homogeneous standards and labels that would enable both market regulators and end-investors to understand what is on the market. An ESG product can be called "ESG" or "sustainable" whereas there is only a review of ESG factors that do not even have a real impact on investment decisions. The case of ESG investment products is very similar to organic food: we need well-known and recognized standards and labels. These standards and labels should in addition enable end-investors to differentiate:

(i) products that are based only on an ESG risk-analysis approach (with a "doing no harm" objective) aimed at avoiding investment in companies with bad practices, from

(ii) products that aim at investing in assets with a positive sustainability impact (in line with the EU taxonomy approach, identifying activities and business models that contribute to the sustainability transition).

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 agree with the high-level principle approach, however it seems to us that the "organizational requirement" should better differentiate the integration ESG <u>risks</u> on the one hand from sustainability investment <u>objectives</u> on the other hand.

We also support the PRI recommendation to add language in Commission Delegated Regulation 2017/565/EU (MiFID II delegated regulation) to provide explicit clarification of the relationship between sustainability and investor duties as articulated in Article 24(1) of Directive 2014/65/EU (MiFID II directive).

3. <u>Product governance</u>

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.

Using recognized and verified labels to take into account the consideration of ESG factors seems to us the best approach. To date, we use mainly the French TEEC label (investing with sustainability objectives) and the French SRI label (ESG risks integration – that should be improved).

The only issue today when relying on these market labels is that they are not homogeneous and mix very different levels of quality under similar denominations. Some of them are only focused on an ESG risks / materiality approach whereas others have sustainability objectives in their investment strategy. For this reason, the HLEG made a difference between minimum ESG (risks) standards, in line with the PRI fiduciary duty approach, and an ambitious EU ecolabel aimed at investing in sustainability impact objectives – both would be extremely useful.

The taxonomy will help structure new European market standards such as the EU ecolabel or the EU green bond standard, but the EU taxonomy will not as such be sufficient to be a market standard:

- it will need to be combined with other criteria in the framework of a standard or label guidelines (like in the TEEC label, defining for instance the percentage of revenue of investee assets that should be green, the size of the authorized diversification pocket, etc) , in order to become usable for investors to take account of ESG considerations.
- It could be added to minimum ESG-risks review requirement (to ensure for instance that when you invest in solar power, which is a environmental investment opportunity, you have verified that you do not at the same time finance child labor, which is a social risk).

We do count on the EU ecolabel to bring concrete solutions to the market and integrate the EU taxonomy through an ambitious and realistic approach.

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 with the general approach suggested, however we would suggest to replace "ESG considerations" by "sustainability investment objectives and ESG risks" in order to make this principle clearer.

With regards to the level of granularity of the market target, we recommend that it should not go beyond expressing a certain level of interest (low, medium or strong) for sustainability objectives, either in general or for social and / or environmental considerations. Going beyond this level of granularity may create so much complexity that investment managers may not be able at this stage to ensure the suitability of products.

Also, we do not see the need to specify everywhere in the regulatory text "where relevant": it is obvious that if there are no specific clients' ESG preferences, they will not have to be taken into account in the definition of the target market and the analysis of the adequation of the product with clients' preferences. Maintaining this mention in the amendments to the may create some confusion given that the "where relevant" is not defined in the text and may integrate the idea that taking into account ESG preferences is not always relevant: although there may be clients with no ESG preferences, the question should always be asked in all cases and the answer taken into account by products manufacturers and distributors.

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 general approach suggested, however we would suggest to replace "ESG considerations" by "sustainability objectives and ESG risks", in order to clarify what is at stake.

Same remark as in answer to Q6 regarding the need to delete the "where relevant" mention.

As regards the addition of an additional case study in the guidelines, we find it appropriate and helpful although a fund so much invested in pure green project is not extremely realistic.

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

We suggest that additional guidance should be provided indeed and that:

- *if a product does not have ESG characteristics while the client has certain ESG preferences:*

in this case the guidance should indicate that the client should not be offered this product in priority. We do not entirely agree with ESMA on the idea that ESG considerations should not be relevant as a factor in the definition of the "negative target market". Clients with certain ESG preferences should be respected and products with ESG characteristics should be offered to them in priority and before non-ESG products. On the contrary, clients with no specific ESG preferences could be offered both "ESG positive products" and "non ESG positive products", provided that these products respect the rest of their preferences.

- *how ESG considerations can be either specified separately from each other or as a single indicator*

We suggest to use simple labels, easy to understand by all clients, that could be of two types:

- if the investment product merely takes account of ESG risks (avoiding pollution, human rights problems… in a doing no harm approach), but with no specific sustainability impact objective, ESG considerations should remain a single indicator; an ESG risks label should be sufficient;
- if the investment product also has a specific / thematic sustainability objective associated with its investment strategy, then this objective should be singled out, ideally with a thematic ecolabel mentioning the sustainability objective along the EU taxonomy categories (like climate mitigation for instance).

- *if ESG considerations of a product are specified separately from each other and a client has differing preferences in all or some of these criteria,* Then only, multithemed approaches that may cover all clients' preferences should be envisaged.

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.

Today, the existing market is based mainly on products with a mere ESG risks analysis approach that cannot easily differentiate the E, S and G criteria. ESG risks analysis should be a minimum basis for products integrating ESG criteria: this is the minimum that the market can do today. Environmental or social investment objectives, such as the ones framed by the French TEEC label on the basis of a taxonomy, are much more ambitious.

We do support a market with high standards and readable for any investor. We suggest indentify ESG, or E and S criteria on the basis of existing market standards: through existing and future SRI and green labels for financial products.

A high degree of granularity may render things too complex to deal with, either for the clients and for investment managers.

4. Suitability

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.

Using recognized and verified labels to take into account the consideration of ESG factors seems to us the best approach. To date, we use mainly the French TEEC label (investing with sustainability objectives) and the French SRI label (ESG risks integration – that should be improved).

The only issue today when relying on these market labels is that they are not homogeneous and mix very different levels of quality under similar denominations. Some of them are only focused on an ESG risks / materiality approach whereas others have sustainability objectives in their investment strategy. This is why the HLEG made a difference between minimum SRI standards and an ambitious EU ecolabel aimed at investing in sustainability impact objectives – both would be extremely useful.

The taxonomy will help structure new European market standards such as the EU ecolabel or the EU green bond standard, but the EU taxonomy will not as such be sufficient to be a market standard:

- it will need to be combined with other criteria in the framework of a standard or label guidelines (like in the TEEC label, defining for instance the percentage of revenue of investee assets that should be green, the size of the authorized diversification pocket, etc) , in order to become usable for investors to take account of ESG considerations.

- It could be added to minimum ESG-risks review requirement (to ensure for instance that when you invest in solar power, an environmental opportunity, you have verified that you do not at the same time finance child labor, which is a social risk).

We do count on the EU ecolabel to bring concrete solutions to the market and integrate the EU taxonomy through an ambitious and realistic approach.

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?

In line with the recommendations of the HLEG on sustainable finance, we support the explicit inclusion of language to draw attention to the importance of proactively seeking to understand clients' ESG preferences, and overall, we agree with approach.

(a) However, the questions asked to end clients should remain extremely simple and understandable.

The following questions could be asked to clients:
- do you intend to have an investment that respects some sustainability criteria?
- What share of your portfolio would you like to respect these sustainability criteria?
- Would you have a preference between social and environmental sustainability objectives?

In our view, asking questions on the basis of the EU upcoming taxonomy will be far too complex for both clients and investment managers to deal with.

(b) With regards to the assessment of ESG preferences with the assessment of suitability, it should remain simple and understandable, and be based on verified high-quality labels, easy to understand and recognizable by all clients. The EU ecolabel will be extremely helpful in this regard.

These market labels could be of two types (and non-exclusive from each other):
- if the investment product merely takes account of ESG risks (avoiding pollution, human rights problems… in a doing no harm approach), but with no specific sustainability impact objective, ESG considerations should remain a single indicator; an ESG risks label should be sufficient;
- if the investment product also has a specific / thematic sustainability objective associated with its investment strategy, then this objective should be singled out, ideally with a thematic ecolabel mentioning the sustainability objective along the EU taxonomy categories (like climate mitigation for instance).

In all cases, we suggest to run some tests on the possible questionnaires that could be asked to clients and on their usability for investment managers.

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.

We suggest to use simple labels, easy to understand by all clients, that could be of two types:

- if the investment product merely takes account of ESG risks (avoiding pollution, human rights problems… in a doing no harm approach), but with no specific sustainability impact objective, ESG considerations should remain a single indicator;
- if the investment product also has a specific / thematic sustainability objective associated with its investment strategy, then this objective should be singled out, ideally with a thematic ecolabel mentioning the sustainability objective along the EU taxonomy categories (like climate mitigation for instance).

In both cases, the suitability assessment should be based on verified labels or standards, ideally in the future these should be EU ones.

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

Yes we overall agree, however we do not seem necessary to specify "where relevant" but we would suggest to replace "ESG considerations" by "sustainability objectives and ESG risks".

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.

No response.