

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

Response by Schroders plc

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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.

Yes.

The suggested high-level approach would emphasise that ESG considerations will impact different areas of an investment firm and allow for a holistic integration.

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.

Yes.

We support a proportionate approach given the fast development of the market and the need for a holistic integration into risk management.

It is important that flexibility in assessing sustainability risks is maintained even as the market matures. The nature of these risks in their long duration and range means that typical risk management techniques which are based on history may prove to be inadequate.

Of course, focusing only on asset managers assessing ESG factors requires appropriate data to feed into this process, hence it must be ensured that the entire investment chain is contributing, i.e. company/investee reporting needs to be strengthened as well.

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?

No.

In line with the high-level principle based approach suggested by ESMA we propose to include a short reference to ESG considerations in the existing recital 59. It is important to recognise that firms are already subject to conflicts of interest rules which should already include any conflicts which might arise in this context. The proposed short reference would ensure that ESG conflicts of interest are not taking precedence over other conflict of interest issues, but are integrated horizontally as any other risk into the advisory process. This would also be in line with the approach taken by the Commission in the draft MiFID Delegated Act published on 4 January 2019. Inserting the reference in recital 59 would have the advantage of embedding sustainable investment issues explicitly in the placing process, organisational requirements and allocation policies (which would, again, apply anyway to any kind of conflicts of interest, including sustainable investment even without mentioning them).

Additionally, changes to the second sentence in recital 59 would underline the link between organisational requirements and addressing potential conflicts of interest (not only relating to sustainable investment issues).

Suggested amendment to Recital 59:

"The placing process involves the exercise of judgement by an investment firm as to the allocation of an issue, and is based on the particular facts and circumstances of the arrangements, which

raises conflicts of interest concerns, including those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments. As part of its policy for managing conflicts, ~~t~~The firm should have in place effective organisational requirements to ensure that allocations made as part of the placing process do not result in the firm's interest being placed ahead of the interests of the issuer client, or the interests of one investment client over those of another investment client. In particular, firms should clearly set out the process for developing allocation recommendations in an allocation policy."

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.

No.

The high-level principle-based approach suggested by ESMA is appropriate given the fast development of the market and the need to integrate ESG considerations holistically as other investment risks.

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.

The sustainability and RI landscape covers a broad range of approaches, each with different objectives and outcomes. Yet existing labels in the market fail to reflect this. They also fail to recognise the importance of ESG integration and active ownership (engagement and voting). We have reviewed several existing European ESG labels and generally found little consistency amongst them. There are different requirements that funds need to meet for the various labels, reflecting definitions which tend to differ across countries, but there are also differences within countries. This is concerning.

Furthermore, a number of labels confuse investment process (how are ESG factors are taken into account) with investment outcomes (how the fund looks on certain E, S or G metrics).

The exception to the above is EuroSIF's European SRI transparency code which focuses on transparency and accountability, and provides a common framework for transparency best practices. It is widely accepted across Europe, and it is a prerequisite for some labels, for example in France. Rather than being overly prescriptive, it recognises the different approaches under the broader ESG and sustainable investment category. Importantly, it doesn't just focus on ticking boxes, exclusions or outcomes – applicants need to explain how ESG factors are taken into account at every step of the investment process.

Apart from labels, it should be remembered that for products produced by financial participants (as opposed to, for example, individual stocks and shares), EU law requires integration of ESG factors in the general investment management process and information on how this is taken into account is available in product documentation.

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.

Yes.

This approach is proportionate and respects that the market is developing fast. We agree that the interpretation of the Commission's initiative here is to identify products which have a "substantial contribution" to ESG objectives. As we set out in our response to question 9 the regulator needs to bear in mind the market response to MiFID product governance requirements was to develop a machine-readable template. The target market indicator relating to "sustainable investments" should therefore focus on identifying "ESG positive products" that can then be matched to investor preferences. Moreover, ESG preferences shouldn't be automatically linked to the taxonomy, which could be a helpful tool for an impact or thematic investment approaches but ignores other effective approaches to sustainable or responsible investing. Also, applying the taxonomy for certain financial products will be practically challenging.

Altogether, it is important to allow sufficient lead time for industry to implement the substantial system changes.

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.

No.

We believe that the suggested case study is overly simplifying ESG products and singling out a very specific model. Given the varied and quite sophisticated client demands, products offered need to offer a wide range of different approaches. Additionally, the market is moving fast, the case study presented risks being outdated quite soon and used as a "tick the box"-template. Overall, we don't think a case study is necessary.

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

Yes.

We believe that additional guidance would be helpful if it took a holistic approach to ESG in contrast to a silo-approach looking at E, S and G separately as bullet point 3 of para. 15 suggests. A holistic approach respects the different approaches to ESG in a fast moving market and the interconnection of E, S and G investment characteristics.

9. 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.

In responding to this question we consider the practical consequences of sustainable investment meaning different things to different people and how the new requirements could be

implemented into the current procedures the industry has developed to meet the MiFID target market requirements, recognising not all distributors sell their own product.

We refer ESMA to our global investor survey of 2018 (<https://www.schroders.com/en/uk/private-investor/insights/global-investor-study/2018-findings/sustainability/>) which asked investors what phrase they thought best described “sustainable investing”. The results show that the phrase means different things to different people. Specifically:

- More than half (52%) said that it was about investing in companies that are likely to be more profitable because they are proactive in preparing for environmental and social change.
- Under half (47%) said it was about investing in companies they thought were best in class when it comes to environmental or social issues or how the company is run.
- A quarter (25%) said it was about avoiding so-called “sin stocks”, companies involved in alcohol, tobacco or weapons manufacturing.
- 9% had no idea what sustainable investing is.

Note that around 1 in 10 investors need educating on sustainability, suggesting advisers need to be able to provide relevant information about what sustainable investment is before asking them their preferences. This also suggests advisers themselves need to have a good understanding of sustainability, indicating a training and competence need, and be cognisant of the fact that once the sustainability package of changes have been implemented, most manufacturers of investment products they will be advising on will have embedded sustainability risks into their systems and controls and disclosed that fact in documentation.

This means the manufacturer of most financial products will favour those companies that are proactive in their preparation for environmental and social change over those that are not since the former’s activities are likely to have a material impact on the value of the investment in that company (they will be more profitable). Put another way, the effect of the overall sustainability package in general is likely to correspond to what the majority of investors believe is “sustainable investing” according to our survey.

A Target market indicator relating to “sustainable investments” should therefore focus on specific products aimed at providing a positive contribution generally to sustainability – “ESG positive product”. Should the client preference be for such a product the adviser can then seek more details. Depending on the client’s specific requirements the product could be, for example, a “best in class” or “thematic” product, a “screened” product (excluding companies involved with certain activities or industries) an “impact” product (seeking specific social benefits).

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 above

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?

No.

Amendments to para. 28 imply that the taxonomy (or any future EU label) is a binding requirement for the purpose of the suitability assessment and hence going beyond the Commission's proposal.

As regards specification of what firms consider to be ESG preferences and considerations, we would like to remind that the Commission's proposals on disclosure require information to the client.

Finally, the latest Commission's draft MiFID Delegated Act of 4 January 2019 clarifies that investment firms shall **"first assess the investor's investment objectives**, time horizon and individual circumstances, **before** asking the client for his or her potential **ESG preferences**" (Recital 6) and that ESG preferences should not take precedence over a client's personal investment objectives, in order to avoid mis-selling. We believe this should be reflected in the guidelines.

Therefore, we suggest para. 28 to run as follows:

"When collecting information about their clients' ESG preferences, firms should ask questions in relation to environmental, social and governance factors. **Investment firms should first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences. Within the suitability assessment process, investment firms should allow for the necessary differentiation between investment objectives on the one hand and ESG preferences on the other hand. This differentiation is important in order to avoid mis-selling, which may happen should an ESG consideration take precedence over a client's personal investment objective.** 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.~~ **Firms should bear in mind that for products produced by financial participants (as opposed to, for example, individual stocks and shares), EU law requires integration of ESG factors in the general investment management process and information disclosure on how this is taken into account is available in product documentation.**"

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.

Environmental, social and governance criteria are not mutually exclusive, on the contrary, they are highly interlinked. However, different investors may prioritise each of them differently. Also, clients demands are usually not “one dimensional”, but very sophisticated and nuanced. Hence, when identifying investor preferences, we advocate for an approach starting with ESG collectively followed by more detailed questions that would allow the identification of aspects a client has a particular focus on (if any). This includes both emphasis between E, S and G but also within e.g. “E”.

However and bearing in mind that E, S and G criteria are interlinked, these questions don’t necessarily have to lead to a product investing solely and exclusively in a very specific ESG aspect (e.g. tackling micro-plastics). Rather, the product needs to be consistent with the client’s individual E, S or G focus (if any).

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

Yes.

However it should be clarified that the reference to existing clients in para. 17 of the CP should be read in the context of ongoing monitoring of the relationship to the client but not as requiring a re-assessment of all clients regardless of the contract. In this respect, we would like to refer to the Commission’ clarification in the draft MiFID Delegated Act of 4 January 2019 it was clarified that a new suitability assessment for existing contracts will generally not be necessary (see recital 8).

14. 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 comment.