



European Securities and
Markets Authority

Consultation Paper

On integrating sustainability risks and factors in MiFID II



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. describe any alternatives ESMA should consider.

ESMA will consider all comments received by **19 February 2019**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper?

This paper is primarily of interest to competent authorities and firms that are subject to Directive 2014/65/EU of the European Parliament and of the Council (MiFID II). In particular, this paper is addressed to investment firms and credit institutions performing investment services and activities and their staff. This paper is also important for trade associations, investors, and consumer groups, because the guidelines seek to implement enhanced provisions to ensure investor protection with potential impact for anyone engaged in the dealing with or processing of financial instruments.



Table of Contents

1	Overview	4
2	Organisational requirements.....	7
3	Product governance	12
4	Suitability.....	21
5	Annexes	26
5.1	Annex I - Summary of questions.....	26
5.2	Annex II – Cost-Benefit Analysis	28



1 Overview

Reasons for publication

1. On 24 July 2018, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) received a formal request (mandate) from the European Commission (Commission) to provide technical advice supplement the initial package of proposals and to assist the Commission on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC (UCITS Directive), Directive 2009/138/EC (Solvency II Directive), Directive 2011/61/EU (AIFMD), Directive 2014/65/EU (MiFID II) and Directive 2016/97/EU (IDD) with regard to the integration of sustainability risks and sustainability factors.
2. The Commission requested ESMA and EIOPA to provide technical advice by no later than 30 April 2019.
3. During the preparation of this Consultation Paper (CP) on the draft technical advice, ESMA and EIOPA have closely liaised to ensure consistency across sectors.

Background

4. Sustainability has long been at the heart of the European project. Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the Commission has expressed in the 'Action Plan: Financing Sustainable Growth' its intention to clarify so-called fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities with the aim to:
 - reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
 - assess and manage relevant financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
 - foster transparency and long-termism in financial and economic activity.
5. On 24 May 2018, the Commission adopted a package of measures on sustainable finance. The package included proposals aimed at establishing a unified EU classification system of sustainable economic activities ('taxonomy'); improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their risk processes; creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.
6. In addition, the Commission has been seeking feedback on amendments to the Commission Delegated Regulation 2017/565 (MiFID II Delegated Regulation) and Commission Delegated Regulation 2017/2359 (IDD Delegated Regulation) to include ESG considerations into the advice that investment firms and insurance distributors offer to



individual clients. Following the public consultations, the Commission intends to adopt the amendments.

7. Following the publication of the Commission's Action Plan on Green and Sustainable Finance in early March 2018, ESMA's Securities and Markets Stakeholder Group (SMSG) decided to provide advice to ESMA on the topic. The advice was approved and published on 20 September 2018.¹
8. With regard to the amendments to delegated acts under MiFID II, the SMSG provided the following recommendation:
 - The SMSG supports the accelerated development of the market to high and consistent standards. The key challenge with the Action Plan and the proposed Regulations package will be to find the right balance in implementation, and not create regulatory complexity or legal uncertainty, as the ultimate goal is to encourage innovation, increase investment and finance for sustainable projects.

In particular, it addresses key qualitative challenge i.e. the risk of green washing which may undermine the reputation of green markets and impede progress.

At the same time, there is a duty of care to avoid being inflexible or overly prescriptive on such a forward-looking topic, as the market has not yet reached maturity and therefore to avoid the risk to put Europe at a global competitive disadvantage. We believe that certain proposals may need adjustment to avoid creating such unintended barriers to market development. Rather a principles-based framework should be favoured.

- The critical prerequisite for an orderly development is a clear and harmonised taxonomy of green assets, project categories and sectors. The Group therefore welcome the Commission Proposal (24.05.2018) on Taxonomy to be finalised with the help of an Expert Group by the end of 2022.
- The global nature and inter-connectedness of sustainability markets calls for international co-operation to avoid regulatory fragmentation, curb incentives for regulatory arbitrage, and spread best practice. Globally consistent taxonomies and standards should be thus sought to achieve such above objectives, in particular with the global bodies.

Cost-benefit analysis

9. A preliminary cost-benefit analysis of the proposals is included in Annex II of this CP.

¹ Ref: ESMA22-106-1301



Contents

10. This CP covers the topics on which the Commission has requested ESMA to provide technical advice, namely: organisational requirements; risk management; product governance. It also includes suggested amendments to the ESMA guidelines on MiFID II product governance requirements² and the ESMA guidelines on certain aspects of the MiFID II suitability requirements³.

Next steps

11. ESMA will consider the responses it receives to this CP in Q1 2019 and expects to publish a final report by 30 April 2019.

² Ref: ESMA35-43-620.

³ Ref: ESMA35-43-869.

2 Organisational requirements

Background/Mandate

Extract from the Commission's request for advice (mandate)

EIOPA and ESMA are invited to provide technical advices on corporate governance mechanisms within the organisation of the financial market participants and investment and insurance advisors, including, where relevant, but not limited to:

- tasks and the role of the risk-management function or procedures for risk assessment, the compliance function, the internal control function or system, the internal audit function and/or the actuarial function in the system of governance and tasks or responsibilities of bodies that undertake the management and supervisory functions in the corporate governance in relation to sustainability risk limits and overseeing their implementation;
- steps of procedures and processes to ensure the effectiveness and adequacy of sustainability risk integration;
- skill, expertise and knowledge required for the assessment of sustainability risks;
- regular reviews of the mechanisms put in place to integrate sustainability risks and regular internal reporting;
- adequate support to (e.g. analysis, research and legal advice), and resources across, all relevant functions and where several functions are involved in the integration of sustainability risks, the requirements on cooperation with each other; and
- measures and policies specifically considering types of conflict of interest that might arise in relation to sustainability considerations and the steps to identify, prevent, manage and disclose them.

Adapting processes, systems and internal controls to reflect sustainability risks is relevant in order to build the technical capacity and knowledge to analyse sustainability risks and ensure that the investment and advisory process is properly implemented and adhered to over time.

1. The relevant MiFID II provisions are included in:

- Article 16 of MiFID II
- Article 23 of MiFID II
- Article 21 of the MiFID II Delegated Regulation
- Article 23 of the MiFID II Delegated Regulation
- Article 33 of the MiFID II Delegated Regulation



Analysis

2. MiFID II, consistently with MiFID I, follows a principled-based approach when setting out requirements on firms' organisational requirements. Under the MiFID II regime, firms must establish adequate policies and procedures to ensure compliance of the firm including its managers, employees and tied agents with its obligations under the MiFID II Directive. Conflicts of interest are explicitly addressed as part of the organisational requirements with which firms must comply. Firms must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients.
3. Within its mandate to ESMA, the Commission clarified that its objective is to explicitly require the integration of sustainability risks (i.e. environmental, social and governance risks) in the investment decision or advisory processes.
4. ESMA considers that the integration of sustainability risks within the MiFID II requirements is better done through a high-level principle-based approach, similar to that already followed for all other relevant risks (e.g. credit risk, market risk, liquidity risk), as detailed prescriptions would enhance the risks of regulatory arbitrage by firms and could result – at this stage - in regulatory errors, especially considering that there are still several ongoing legislative workstreams in this area (e.g. the Commission's proposals on the establishment of a framework to facilitate sustainable investments; on disclosures relating to sustainable investments and sustainability risks; on benchmarks; and on the establishment of a unified EU classification system of sustainable economic activities ('taxonomy')).
5. Following this principle-based approach, ESMA suggests inclusion of a reference to ESG considerations in:
 - Article 21 of the MiFID II Delegated Regulation on "General organisational requirements";
 - Article 23 of the MiFID II Delegated Regulation on "Risk management";
 - a new recital on the topic of 'conflicts of interest'.

General organisational requirements

6. ESMA believes that through the amendment of Article 21 of the MiFID II Delegated Regulation firms would be expected to incorporate ESG considerations within their processes, systems and controls in order to ensure the investment and advisory process correctly takes them into account.
7. For example, in light of the technical advice mentioned above, firms will be expected to ensure that staff involved in the advisory process possess skills, knowledge and expertise for the assessment of sustainability risks.

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.

Risk management

8. ESMA considers that the suggested change to Article 23 of the MiFID II Delegated Regulation meets the objectives set out in the Commission's request for advice, in terms of organisational requirements. However, introducing sustainability risks in other articles of the organisational requirements section does not appear appropriate. In other articles of this section, the concept of 'risk' is only referred to very broadly or not mentioned at all. Therefore, 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. This approach does not preclude the possibility for ESMA to provide investment firms with further guidance in the future on this matter if need be (for example, through new Q&As).
9. The Commission is currently developing a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity. By identifying activities that, in the Commission's view, qualify as sustainable, businesses and investors will be provided with a common language to identify to what degree economic activities can be considered environmentally-sustainable. ESMA is aware that this taxonomy will be finalised in the upcoming years and that, at least initially, it will not cover social and governance issues. 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.⁴ Considering on-going regulatory efforts on disclosure and transparency in the area of sustainable finance, search costs can be expected to decrease over time, and firms should be able to improve in parallel their internal policies and procedures to manage sustainability risks.
10. ESMA believes that some of the services offered by investment firms and activities they carry out should indeed be impacted by sustainability risks. These include for example portfolio management, whereby an investment policy that ignores environmental considerations leaves the possibility for clients to invest in stranded assets. Similarly, firms providing investment advice may want to consider the long-term impact on client returns of investing in mainstream benchmarks relative to low-carbon alternatives, as the EU economy and broader investment community transition to a low-carbon economy.
11. ESMA would like to emphasize that, through the inclusion of a reference to ESG considerations in Article 23 of the MiFID II Delegated Regulation, it would also be expected that both the Compliance function and Internal Audit will consider issues related to

⁴ For additional details on these search costs, see the European Commission's impact assessment (SWD(2018) 264) accompanying the three Proposals for a Regulation in the area of sustainable finance.



sustainability risks, as both functions are responsible of monitoring the adequacy and effectiveness of the firms' risk management policies and procedures.

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.

Conflicts of interest

12. ESMA considers it also useful to add a recital, in the MiFID II Delegated Regulation, on the topic of 'conflicts of interest', in order to clarify that when identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that stem from the distribution of (i) investments in companies that adopt environmentally sustainable practices, are socially responsible, and/ or have good corporate governance; or (ii) financial instruments that provide exposure to sustainable investments, social investments, and/or good governance investments.
13. ESMA believes that the addition of the recital is important to ensure that firms have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process does not lead to mis-selling practices or misrepresentations and does not damage the interest of the client (for example as an excuse to sell own-products or more costly ones, or to generate unnecessary churning of clients' portfolios, or by firms misrepresenting products or strategies as fulfilling ESG preferences where they do not).
14. Finally, considering the relevance of these conflicts of interest and the new proposed recital, firms would be expected to include a clear reference in their conflict of interests policy on how they are identified and managed.
15. As a general consideration, ESMA notes that changes introduced through the draft technical advice should all be applied by firms with the proportionality principle in mind, taking into account the size, nature, scale and complexity of their activities.

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?

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.



Proposals

Draft technical advice to the European Commission

Article 21(1) of the MiFID II Delegated Regulation to be amended as follows

Investment firms shall comply with the following organisational requirements:

[...]

When complying with the requirements set out in this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.

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.

Article 23 of the MiFID II Delegated Regulation to be amended as follows

Investment firms shall take the following actions relating to risk management:

(a) establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall take into account environmental, social and governance factors.

[...]

New recital 59 (bis) of the MiFID II Delegated Regulation to be added

When identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments.

Firms should have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process and portfolio management does not lead to mis-selling practices.



3 Product governance

Background/Mandate

Extract from the Commission's request for advice (mandate)

The conditions to identify a target market in Commission Delegated Directive 2017/593 adopted under Articles 16(12) and 24(13) of MiFID II and Commission Delegated Regulation 2017/2358 adopted under Article 25(2) of IDD do not explicitly establish the details of the integration of sustainability factors by investment firms manufacturing financial instruments and their distributors and insurance undertakings, intermediaries manufacturing insurance products for sale to customers and insurance distributors referred to in Article 2 of Commission Delegated Regulation 2017/2358 respectively.

In order to ensure that products and, where relevant, the related services are offered in the interest of clients and that sustainability factors are taken into account in the target market assessment, EIOPA and ESMA should analyse the relevant changes to Commission Delegated Regulation 2017/2358, in particular Articles 5 to 11, and Commission Delegated Directive 2017/593, in particular Articles 9(9), 9(11), 10(2) and 10(5).

This approach should duly consider the existing ESMA Guidelines on MiFID II product governance requirements that already provide a good indication on how sustainability factors should be taken into account when identifying the target market. ESMA should ensure that changes to the definition of the target market do not lead to miss-selling practices, e.g. by clearly identifying investment objectives and ESG constraints. In addition, the possibility to identify a target market for clients without ESG preferences should be maintained. When establishing a requirement to consider sustainability factors under the client's objectives and needs, EIOPA and ESMA should also take existing practices for the identification of the target market into account.

The technical advices should be consistent with each other, while recognizing, where relevant, the difference in terminology used by IDD and MiFID II. The technical advices should list in mapping the provisions of delegated acts that should be amended.

1. The relevant MiFID II provisions are included in:

- Recital 71 of MiFID II
- Article 16(3) of MiFID II
- Article 24(2) of MiFID II
- Recitals 15 to 20 of the Commission Delegated Directive 2017/593 (MiFID II Delegated Directive)
- Articles 9 and 10 of the MiFID II Delegated Directive

Analysis

2. The objective of the MiFID II product governance requirements is to ensure that firms, which manufacture and distribute financial instruments and structured deposits, act in the clients' best interests during all the stages of the life-cycle of products or services.
3. The product governance requirements, as laid down in Articles 16(3) and 24(2) of MiFID II as well as in Articles 9 and 10 of the MiFID II Delegated Directive, cover a broad range of topics, both product and process related. Considering the key investor protection role of these requirements, ESMA developed Guidelines on MiFID II product governance requirements which focus on the 'target market assessment', as this aspect was identified as the most important one for ensuring the common, uniform and consistent application of the above-mentioned articles. In fact, the target market is significant not only for manufacturing a product, but also its distribution and review. Hence, it influences all the stages of the life-cycle of products more than any other element of product governance. The target market is therefore the preferred choice for the integration of ESG considerations.
4. ESMA proposes amendments to the MiFID II Delegated Directive (Articles 9 and 10) as well as to the Guidelines on MiFID II product governance requirements. For both amendments ESMA proposes a principle-based approach: the MiFID II Delegated Directive addresses amendments to product governance through principle-based provisions which leave sufficient flexibility for implementation by Member States and supervisory approaches. In its advice, therefore, ESMA proposes to include a simple reference to "ESG preferences" in the relevant articles.
5. ESMA has included the proposed amendments to the Guidelines on MiFID II product governance requirements in this CP in order to align them to the changes proposed in this CP to the MiFID II Delegated Directive. ESMA is aware that these amendments might need to be revised should the Commission not follow the advice when finalising the changes to the MiFID II Delegated Directive. Nevertheless, ESMA wants to give market participants the opportunity to comment on these proposals in conjunction with the draft technical advice.
6. ESMA considers that both the manufacturer and distributor should take into account ESG preferences or ESG considerations while identifying the target markets for the financial instruments they manufacture or distribute. Thus, the proposals affect provisions that apply to both manufacturers and distributors.

MiFID II Delegated Directive

7. ESMA considers that amendments should be made to paragraphs 9, 11 and 14 of Article 9.

- Paragraph 9 introduces the manufacturer’s obligation to identify the target market for the investment products it manufactures. ESMA proposes an explicit reference to ‘ESG preferences’ for manufacturers in specifying the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible with.
 - Subsequently, paragraph 11 requires manufacturers to perform the target market assessment in consideration of the respective product's risk/reward profile and (beneficial) product features. ESMA proposes to make it explicit at this point, that this assessment should also cover the ESG characteristics of financial instruments.
 - Paragraph 14 covers the manufacturer’s periodic review requirement of the financial instruments it manufactures. In the context of this review, manufacturers should also explicitly take clients’ ESG preferences into account.
8. When setting out the ESG preferences that an investment product fulfils (where relevant), firms should rely on the categorisations that are being defined by the Commission in the taxonomy. Until the Commission’s taxonomy is completed, such a specification should take into account current market standards and the preparatory work that has been published by the Commission. For example, the Commission’s Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment already specifies that the taxonomy shall initially include six environmental objectives⁵ which could already be used to substantiate the target market description of which ESG preferences a product fulfils.
9. ESMA notes that manufacturers and distributors should specify with a meaningful level of granularity which ESG preferences the investment product fulfils. For example, it would not be sufficient to specify that the investment product has, as a target market, clients who are interested in environmentally sustainable, social and good governance investments. Firms should instead specify more precisely which ESG preferences it fulfils.
- 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.⁶**
10. ESMA notes that these proposed amendments do not require that all investment products always need to have a reference, in their target market, as to whether the products fulfils ESG preferences or not. It does require, however, that manufacturers need to assess whether products possess identified ESG characteristics. ESMA interprets the initiative of the Commission in a way that “positive” ESG characteristics of a product shall be identified

⁵ These are: (1) climate change mitigation; (2) climate change adaptation; (3) sustainable use and protection of water and marine resources; (4) transition to a circular economy, waste prevention and recycling; (5) pollution prevention and control; and (6) protection of healthy ecosystems.

⁶ An overview of existing national eco-labelling schemes has been included by the European Commission in Section 2.2.3 of its ‘Commission Staff Working Document – Impact Assessment’ [Ref: SWD(2018) 264 final]. These include:

- TEEC Label (France)
- FNG Siegel (Germany)
- Luxflag Climate Finance Label (Luxembourg)
- Swan Ecolabel (nordic countries)

so that it will be easier to identify which investment products provide a substantial contribution to environmental, social and/or good governance objectives. In contrast, firms are not expected to identify products that have negative impact on these objectives. Generally speaking, this will result in two types of target market: target markets in which certain ESG characteristics are specified ('ESG positive products') and target markets without any reference to ESG characteristics ('non ESG products'). That is why ESMA proposes to include 'where relevant' in paragraphs 9 and 14 of Article 9 of the MiFID II Delegated Directive.

11. The proposed amendments to Article 10 (the requirements for the distributor) follow the same approach as the proposals for Article 9. Paragraph 2 entails the initial target market assessment and paragraph 5 the review requirement. For both paragraphs, ESMA proposes to include an explicit reference to ESG preferences.

ESMA Guidelines

12. ESMA proposes a similar high-level approach on amending the Guidelines. In ESMA's view, the section relating to 'client's objectives and needs' of guideline 18(e) should be amended. Guideline 18 sets out the details of the target market assessment, and all other guidelines build upon or presume this specification. Therefore, guideline 18 is the preferred location to embed ESG considerations. In addition, the 'client's objectives and needs' category already contains references to ESG-like objectives (e.g. reference to "green investment", "ethical investment" in guideline 18(e) at the end) so that the inclusion of ESG preferences is a consistent substantiation.
13. As explained in the ESMA Guidelines on product governance, including a reference to clients' ESG preferences in the "objectives and needs" category does not necessarily imply that the investment product is not compatible with clients who do not have those specific objectives or needs. This product would not, due to this fact alone, be incompatible with clients who do not have the ESG preferences that this investment product intends to fulfil. Therefore, with regard to the ESG preferences in the 'objectives and needs' category, a negative target market does not need to be specified. Whether the product will be compatible with clients who do not have these ESG objectives, will have to be determined by considering the other target market categories for this investment product.
14. In the amendments to the guidelines, ESMA has also included a new case study on the target market for a green investment product in order to provide further clarification on the application of the revised guidelines.
15. Finally, while ESMA is of the view that, considering the approach followed by the Commission in the definition of the EU taxonomy (see paragraph 10, above) ESG considerations should not be relevant as a factor in the definition of the "negative target market", it is looking forward to stakeholder views on whether further guidance is needed on aspects such as:

- how the target market assessment and the matching of a client vis-à-vis the target market should be done if a product does not have ESG characteristics while the client has certain ESG preferences.
- how ESG considerations can be either specified separately from each other or as a single indicator.
- how the target market assessment and the matching of a client vis-à-vis the target market should be done 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 (e.g. a product shows strong environmental criteria and little governance criteria while the client has little environmental preferences and strong governance preferences).

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.

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.

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

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.

Proposals

Draft technical advice to the European Commission

Article 9(9) of the MiFID II Delegated Directive to be amended as follows

Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, including ESG preferences (where relevant), the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.

Article 9(11) of the MiFID II Delegated Directive to be amended as follows

Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:

- a) the financial instrument's risk/reward profile is consistent with the target market;
and
- b) the financial instrument's ESG characteristics (where relevant) are consistent with the target market; and
- c) financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable.

Article 9(14) of the MiFID II Delegated Directive to be amended as follows

Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives, including ESG preferences (where relevant), of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible.

Article 10(2) of the MiFID II Delegated Directive to be amended as follows

Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, including ESG preferences (where relevant), of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, firms shall identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible.

Article 10(5) of the MiFID II Delegated Directive to be amended

Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives, including ESG preferences (where relevant), of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified

target market, such as where the product becomes illiquid or very volatile due to market changes.

Amendments to ESMA Guidelines on MiFID II product governance requirements

Paragraph 18 of the guidelines to be amended as follows

Manufacturers should use the following list of five categories:

[...]

[...]

[...]

[...]

- (e) Clients' Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is designed to meet including ESG preferences of the client (where relevant) and the wider financial goals of target clients or the overall strategy they follow when investing. For example, reference could be made to the expected investment horizon (number of years the investment is to be held). Those objectives can be “fine-tuned” by specifying particular aspects of the investment and expectations of targeted clients. The particular clients' objectives and needs a product is intended to fulfil may vary from specific to more generic. For example, a product may be designed to meet the needs of a specific age demographic, to achieve tax efficiency based on clients' country of tax residence, or be designed with special product features to achieve specific investment objectives such as “currency protection”, “green investment”, “ethical investment”, etc., as relevant.

New case study to be added

Case study 6 – Simple investment fund

Product: Impact investment fund

An open end fund with variable capital, investing in renewable energy, organic farming, sustainable real estate, nature and landscape projects and environmental technology. The fund aims to provide explicit positive impact on the environment, measured in carbon-footprint, as well as a positive cash flow to its investors, created by the projects funded. The fund invests mainly in loans, secured by mortgages, (state) guarantees, or alternative collateral. The risk indicator of this fund is 2 on a scale of 7 (low risk, low return). More than 70% of the fund is invested in projects certified as “green projects”. The fund is priced daily. Investors can buy or sell shares in the fund every trading-day. A key investor information

document (KIID) is issued in accordance with the UCITS directive, the KID Regulation for PRIIPs and national law.

Target market

Type of client: Retail, professional clients and eligible counterparties.

Investor knowledge and experience: clients with average knowledge and experience, which could consist for example of:

- experience with investing in non-guaranteed financial products such as bond funds;
- some knowledge about the influence of market interest rates on the return of the fund
- understanding the concept of dividends and ability to choose pay-out or re-invest;

Investor's financial situation with a focus on the ability to bear losses: ability to bear [x]⁷% capital loss.

Risk tolerance and compatibility of the risk profile of the product with the target market: the product has an [x⁸] risk & reward profile and is therefore compatible with clients need to have a low⁹ risk tolerance;

Client objectives and needs:

- longer term investment horizon (5-year horizon or longer) as the longer the holding period, the smaller the influence of interest rate fluctuations on the return for the investor;
- potential of earning a higher return than in a savings account at only slightly increased risk.
- steady increase in value and/or annual steady dividend over a longer holding period;
- specific ESG preferences: positive impact on the environment by investing capital in green projects, while preserving capital; In particular the product can help fulfil the objectives of 'climate change mitigation', 'pollution prevention and control' and 'protection of healthy ecosystems'¹⁰;

Clients who should not invest (the 'negative target market'):

⁷ The firm should specify the percentage based on the characteristics of the product.

⁸ The firm should use the risk indicator of the UCITS KIID/PRIIPs KID.

⁹ In line with paragraph 20 of the guidelines, firms should clearly define concepts and terminology used.

¹⁰ These objectives, which have been included as an indicative example, are taken from the European Commission's Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment.

- clients who are unwilling or unable to accept the possibility of eroding value, despite enjoying fiscal benefits and dividends over the years;
- are fully dependent on the dividends for their income

Distribution channel

In light of the target market analysis, the product can be promoted widely with or without advice, with no additional restrictions on distributors.

4 Suitability

Background/Mandate

1. In March 2018, the Commission published its Action Plan on Financing Sustainable Growth. In the Action Plan the Commission noted that “By providing advice, investment firms and insurance distributors can play a central role in reorienting the financial system towards sustainability. Prior to the advisory process, these intermediaries are required to assess clients' investment objectives and risk tolerance in order to recommend suitable financial instruments or insurance products. However, investors' and beneficiaries' preferences as regards sustainability are often not sufficiently taken into account when advice is given. The Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD) require investment firms and insurance distributors to offer 'suitable' products to meet their clients' needs, when offering advice. For this reason, those firms should ask about their clients' preferences (such as environmental, social and governance factors) and take them into account when assessing the range of financial instruments and insurance products to be recommended, i.e. in the product selection process and suitability assessment.”
2. Following the Action Plan, in May 2018, the Commission launched a consultation to assess how best to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The aim is to amend Delegated Acts under the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive. When assessing if an investment product meets their clients' needs, firms should also consider the sustainability preferences of each client, according to the proposed rules. This should help a broader range of investors access sustainable investments.
3. In addition to the above, the Commission has invited ESMA to include provisions on sustainability preferences in its guidelines on the suitability assessment¹¹.

Analysis

4. Within its consultation document¹² on the proposed changes to the MiFID II Delegated Regulation on the topic of suitability, the Commission stated that information gathered by firms for the purpose of the MiFID II suitability assessment, usually relates to financial objectives while non-financial objectives of the client, such as environmental, social and governance (ESG) preferences, are usually not addressed.
5. During the preparation of its MiFID II guidelines on certain aspects of the MiFID II suitability requirements (suitability guidelines)¹³, ESMA had already considered input received by respondents during the public consultation of the guidelines and the Commission's Action Plan on 'Financing Sustainable Growth', and had decided to include – at that stage – a

¹¹ See Action 4 of the Commission's Action Plan on Financing Sustainable Growth.

¹² Ref: Ares(2018)2681527 - 24/05/2018

¹³ ESMA35-43-869.

good practice provision for firms to consider non-financial elements when gathering information on the client's investment objectives, and collect information on the client's preferences on environmental, social and governance factors.¹⁴

6. ESMA now suggests amendments to paragraph 28 and 70 of the Guidelines on certain aspects of the MiFID II suitability guidelines based on the legislative proposal of the Commission. These paragraphs note that firms are expected to (i) take into account ESG preferences in the context of assessing client's investment objectives and (ii) to consider ESG factors in the context of product classification. With these amendments, ESMA suggests at this stage the adoption of a high-level approach that leaves sufficient flexibility for implementation by firms and for developing some supervisory practice by NCAs in a field where, at present, there is very limited practical experience.
7. As noted in the section on product governance of this CP, the Commission is currently developing a taxonomy on what can be considered an environmentally sustainable economic activity. Until an unified EU classification is finalised, investment firms should clearly specify what they consider to be ESG preferences or ESG considerations, while taking into account current market standards.

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.

8. ESMA considers that amendments should be made to paragraph 28 of the suitability guidelines in light of the recent changes to the MiFID II Delegated Regulation. Whereas paragraph 28 of the current guidelines notes that it would be a 'good practice' for firms to consider non-financial elements when gathering information on the client's investment objectives, the proposals strengthen the approach by clarifying that firms 'should' collect information from clients in relation to their ESG preferences.
9. In ESMA's view, firms should decide how best to incorporate clients' ESG preferences within their existing suitability processes. In light of this, the proposed amendments do not set out a specific approach to be followed.
10. ESMA has not suggested any change to guideline 2 of the suitability guidelines, but reminds firms that, when collecting information on clients' ESG preferences, firms should be aware and consider the most common reasons why investors could fail to answer questionnaires correctly (see paragraph 25 of the suitability guidelines). Firms should aim to prevent any perceptible or cognitive distortion from impairing the answer provided by investors and affecting their validity and their reliability¹⁵ (for example, in the context of questions based on self-assessment of clients' ESG-preferences). The willingness of a

¹⁴ See paragraph 28 of the guidelines (Ref: ESMA35-43-869).

¹⁵ See pages 9-12 of the Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements (Ref: ESMA35-43-748).



client to invest in environmentally sustainable, social or good governance products should not be used against the interests of that client.

11. ESG considerations should contribute as an additional aspect to the other suitability criteria as identified by the relevant provisions (knowledge and experience, financial situation and financial investment objectives) to ascertain whether a given product is or not suitable for a client. It is important that sustainability considerations do not outweigh the relevance of the other suitability criteria in a way that might not result in the client's best interest. Therefore, ESG preferences should only be addressed once the suitability has been assessed in accordance with the criteria of knowledge and experience, financial situation and investment objectives. Once the range of suitable products has been identified following this assessment, in a second step the product that fulfils best the client's ESG preferences should be chosen.
12. ESMA also notes that, as for the other criteria that are relevant for the assessment of suitability, firms can develop different methodological approaches to achieve compliance with the MiFID requirements. For example:
 - a simplified approach where clients are asked what percentage of their portfolio they wish to invest in environmentally sustainable investments, social investments and/or good governance investments;
 - or a more advanced "portfolio approach" where, based on a client's preferences for environmentally sustainable investments, social investments, and/or good governance investments, the firm is able to calculate the 'ESG profile' of the client's portfolio and assess it against the client's ESG preferences.²
13. ESMA also highlights that the assessment of clients' ESG preferences in the context of the suitability assessment should not be linked to the size of clients' portfolios. As set out in the 2018 Final Report by the EU High Level Expert Group on Sustainable Finance¹⁶, over two thirds of retail investors considering environmental and social objectives as important for their investment decisions. Therefore, the assessment of ESG preferences should not be limited to wealthier clients.
14. The amendments introduced in MiFID II on the topic of the suitability assessment will require firms to take into account ESG considerations in the investment and advisory process as part of their duties towards clients. ESMA wishes to clarify that this does not imply:
 - that environmentally sustainable investments, social investments and good governance investment should automatically be deemed unsuitable for clients that do not have ESG preferences. Whether this product will be suitable for clients who do not

¹⁶ https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

have these ESG-objectives, will have to be assessed according to the other criteria to be taken into account in the suitability assessment; or

- that investments that are not categorised as environmentally sustainable investments, social investments or good governance investments should automatically be deemed unsuitable for clients who have expressed ESG preferences. As set out in paragraph 13, above, different methodological approaches are possible on how to incorporate ESG considerations in the assessment of suitability.

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?

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.

15. ESMA considers that amendments should be made to paragraph 70 of the suitability guidelines in light of the recent changes to the MiFID II Delegated Regulation. More specifically, ESMA believe it is important to clarify that ESG considerations should be taken into account by firms, when classifying products, in order to assess whether these products are suitable for clients who have expressed ESG preferences. To this end, firms should also take into account the analysis conducted for the purposes of product governance requirements, similarly to what is done in relation to other product features.

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

16. With regard to the time that firms would have to make the necessary changes in order to comply with the guidelines, ESMA notes that the updated MiFID II Delegated Regulation will apply 18 months after the date of entry into force. The amended guidelines will apply only after this date, and also 60 calendar days after the reporting requirements for national competent authorities set out in paragraph 13 of the guidelines.

17. Furthermore, ESMA wishes to clarify that the amendments apply to all kind of clients, including existing clients. However, firms would not be expected to immediately update clients' profiles. Nevertheless, ESMA expects firms to take into account these amendments when they review the clients' profiles. This could be, for example, the regular review of clients' profiles according to the firm's policy. Firms are reminded that they should have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the suitability assessment does not lead to mis-selling practices and does not act against the interests of the client.



Amendments to ESMA Guidelines on certain aspects of the MiFID II suitability requirements

Paragraph 28 of the guidelines to be replaced by the following

When collecting information about their clients' ESG preferences, firms should ask questions in relation to environmental, social and governance factors. 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.

Paragraph 70 of the guidelines to be amended as follows

Firms should adopt robust and objective procedures, methodologies and tools that allow them to appropriately consider the different characteristics (including, where relevant, ESG considerations) and relevant risk factors (such as credit risk, market risk, liquidity risk¹⁷, ...) of each investment product they may recommend or invest in on behalf of clients. This should include taking into consideration the firm's analysis conducted for the purposes of product governance obligations¹⁸. In this context, firms should carefully assess how certain products could behave under certain circumstances (e.g. convertible bonds or other debt instruments subject to the Bank Recovery and Resolution Directive¹⁹ which may, for example, change their nature into shares).

¹⁷ It is particularly important that the liquidity risk identified is not balanced out with other risk indicators (such as, for example, those adopted for the assessment of credit/counterparty risk and market risk). This is because the liquidity features of products should be compared with information on the client's willingness to hold the investment for a certain length of time, i.e. the so called 'holding period'.

¹⁸ In particular, MiFID II requires firms (under subparagraph 2 of Article 24(2)) to '*understand the financial instruments they offer or recommend*' in order to be able to comply with their obligation to ensure the compatibility between products offered or recommended and the related target market of end clients.

¹⁹ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 190–348).

5 Annexes

5.1 Annex I - Summary of 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.**
- 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.**
- 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?**
- 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.**
- 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.²⁰**
- 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.**
- 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.**
- Q8: Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.**
- 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.**

²⁰ An overview of existing national eco-labelling schemes has been included by the European Commission in Section 2.2.3 of its ‘Commission Staff Working Document – Impact Assessment’ [Ref: SWD(2018) 264 final]. These include:

- TEEC Label (France)
- FNG Siegel (Germany)
- Luxflag Climate Finance Label (Luxembourg)
- Swan Ecolabel (nordic countries)



- 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.**
- 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?**
- 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.**
- Q13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?**
- 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 relevant²¹.**

²¹ See table provide on page 33.

5.2 Annex II – Cost-Benefit Analysis

Background

1. Sustainability has since long been at the heart of the European project. The EU Treaties give recognition to its social and environmental dimensions. The 2016 Commission's Communication on the next steps for a sustainable European future links the Sustainable Development Goals (SDGs) of the UN 2030 Agenda for Sustainable Development to the European policy framework to ensure that all EU actions and policy initiatives, within the EU and globally, take the SDGs on board at the outset. The EU is also fully committed to reaching the EU 2030 climate and energy targets and to mainstream sustainable development into EU policies. As a consequence, many of the Commission's policy priorities for 2014-2020 feed into the EU climate objectives and implement the 2030 Agenda for Sustainable Development.
2. This CP aims at fulfilling the Commission's request for technical advice (mandate) on potential amendments to, or introduction of, delegated acts under Directive 2014/65/EU with regard to the integration of sustainability risks and sustainability factors in firms' internal processes and procedures. In addition, the CP proposes changes to ESMA guidelines on MiFID II product governance requirements with regard to the section relating to clients' objectives and needs (complemented by a new case study on the target market for a green investment product) and to ESMA guidelines on certain aspects of MiFID II suitability requirements.
3. In particular, and in accordance with the Commission's mandate, ESMA is proposing changes in the following areas of the MiFID II framework.
4. Organisational requirements and operating conditions, with particular reference to:
 - General organisational requirements (Article 21(1) of MiFID II Delegated Regulation)²²
 - Risk management (Article 23 of MiFID II Delegated Regulation)
 - Conflicts of interest (recital of MiFID II Delegated Regulation)
5. Product governance, with particular reference to:
 - Manufacturers' obligations on the definition and review of the target market (Articles 9(9), 9(11) and 9(14) of MiFID II Delegated Directive²³);

²² Commission Delegated Regulation (EU) 2017/565.

²³ Commission Delegated Directive (EU) 2017/593.

- Distributors' obligations on the definition and review of the target market (Articles 10(2) and (5) of MiFID II Delegated Directive),
 - Clients' objectives and needs (Guideline 18(e) of ESMA guidelines on MiFID II product governance requirements²⁴).
6. Assessment of suitability: although not included in the Commission's mandate, changes are proposed to ESMA guidelines on certain aspects of MiFID II suitability requirements²⁵ in light of the amendment to (Articles 2, 47, 48, 52 and 54 of) MiFID II Delegated Regulation. In particular, this CP proposes changes to the following parts of ESMA guidelines on suitability:
- Assessment of clients' objectives ("know your clients") in paragraph 28
 - Product classification ("know your product") in paragraph 70
7. The policy drafting approach followed by ESMA when designing this CP for the identification of changes to MiFID II delegated acts and to ESMA guidelines is consistent with the one adopted by the Commission when designing the CP on changes to (*inter alia*) MiFID II delegated regulation. In particular, references to: ESG considerations²⁶ or ESG preferences have been added to relevant MiFID II delegated provisions or to ESMA guidelines.

The impact of the proposed changes

8. In line with the European Union's commitment for a sustainable development as pointed out in the package of measures on sustainable finance adopted by the Commission on May 2018, this CP is proposing changes to MiFID II implementation acts to accomplish the mandate received by the Commission on July 2018 aiming at integrating sustainability risks (i.e. environmental, social and governance risks) in the investment decision or advisory processes as part of duties towards investors and/or clients. In particular, it should be observed that certain investors have explicit ESG preferences that might be not sufficiently addressed and that for these investors, it is important that their personal values are considered in the advisory process and reflected in the investment product selection.
9. As a matter of consistency, this CP is proposing also changes to those ESMA guidelines adopted within the framework of the relevant MiFID II legislation in order to maintain a common and consistent understanding and implementation of the MiFID II requirements related to the definition (and the review/update) of the target market for manufacturers and distributors when complying with MiFID II product governance requirements and to the assessment of suitability by providing explanations, clarifications and examples on how the relevant obligations should be fulfilled. The new draft guidelines also aim at ensuring a

²⁴ Guidelines on MiFID II product governance requirements, 05/02/2018 | ESMA35-43-620.

²⁵ Final Report on Guidelines on certain aspects of the MiFID II suitability requirements, 28 May 2018 | ESMA35-43-869.

²⁶ According to the Commission's proposal to amend MiFID II delegated regulation, "ESG considerations" means a consideration related to environmentally sustainable investments, social investment or good governance investments" (proposed new paragraph 8 of Article 2 of MiFID II delegated regulation).



convergent approach in the supervision of the product governance and suitability requirements by National Competent Authorities (NCAs). Greater convergence leads to improved investor protection (consumer outcomes), which represents a key ESMA objective.

10. In light of the main focus of this CP, ESMA has prepared a preliminary qualitative cost-benefit analysis where some possible costs and benefits of the proposed changes are identified and described. In this context, ESMA took also into account that the absence of a common methodology to understand what constitutes a sustainable economic activity, for investment purposes, could have an impact on the comparability among financial instruments. This might imply costs for manufacturers and distributors (while assessing relevant products in accordance with different standards or metrics or when classifying product for the purposes of suitability requirements) and reduce possibilities for investors to effectively compare the standards of ESG-related disclosures across different companies or investments. Until public or private sectors are able to (at least) identify common standards for the classification or the labelling of relevant financial products, this might have an impact on the demand for sustainable investments.
11. The risk of confusing (or distorting) markets should also be carefully considered in this context. One of the essential functions of financial markets is to price risk in order to support informed, efficient capital-allocation decisions. A precise and well-timed disclosure of financial results is fundamental to this purpose, but it is increasingly important that robust governance and risk management arrangements are in place.

Benefits

12. The main positive effect of the proposed changes should consist in an improved and more effective compatibility between investment products and investor preferences and characteristics which should lead to an increased quality of the services and products offered and sold to investors. The proposed changes will provide clarity on the fact that existing MiFID II duties will require firms to assess ESG factors and to take them into account when serving their clients. This will improve the quality of the services provided by ensuring:
 - a more adequate risk management by relevant entities enhancing the risk-adjusted performance of their products and services benefitting end-investors, particularly over the long-term;
 - a coherent approach across sectors and Member States with regard to the integration of ESG factors by relevant entities covering, among others, the areas of corporate governance, suitability assessment and risk management;
 - that entities providing investment advice and portfolio management assess their clients' ESG preferences in their suitability test.
13. An increased number of end-investors would be able to express their ESG preferences in the suitability assessment and to see them reflected in the products they purchase.

Investors will be therefore allowed to take investment decisions that better correspond to their preferences in an easier and (presumably) less-costly manner²⁷.

14. On the other side, reputational benefits from increased disclosure and integration of ESG factors in firms' processes might attract new investors and increase trust in the financial system. Evidence mentioned in the Impact Assessment presented by the Commission suggests that the markets will reward companies that come up with innovative approaches to address ESG factors.

Costs

15. The costs for firms of integrating ESG factors in their internal processes and in their investment decisions and advisory processes are expected to remain relatively limited. Relevant entities that have not already integrated ESG factors within their processes, will need to invest (financial) resources to obtain ESG expertise, data and tools to assess and integrate ESG factors in the investment / advisory processes. As also explained in the Impact Assessment provided by the Commission²⁸, the feedback received from stakeholders during targeted interviews suggests that these costs should be limited because firms are expected to rely on their existing tools/methodologies.
16. In particular, the need for firms to hire new staff it did not emerge. It is rather a question of investing more systematically in ESG expertise (e.g. at employee and board training), data and tools. Depending on the current level of ESG integration at firm level, this could also involve buying ESG data from third-party vendors, more systematic integration in the investment decision process and risk assessment, and possible further task specialisation and more active engagement with companies on topics related to ESG.
17. ESMA considers that the potential and incremental costs that firms will face when reviewing and updating internal processes and procedures in order to integrate ESG factors might be both one-off and ongoing, arguably linked to: a) (direct) costs linked to the update/review of the existing procedural and organisational arrangements (e.g. the review and/or the update of the arrangements for the identification of the target market, for the design of questionnaires and of the algorithms/models used to match the client's profile with suitable financial instruments, including ESG-related ones) b) (direct) initial and ongoing IT costs to update current structures and programs; c) (direct) relevant organisational and HR costs linked to the qualification of firm staff (in particular compliance function staff and staff providing relevant investment services) or training for board members; d) (possible, depending on current arrangements of relevant firms) direct and on-going costs for buying ESG data from third-party vendors; e) initial and on-going costs for reviewing and updating existing risk-management and compliance arrangements.

²⁷ It should be noted that the magnitude of the described benefits might be affected by the fact that diverging ESG approaches would persist as Member States and/or relevant entities can adopt different approaches. As a consequence, it is not ensured that (i) a given product or service will have an optimal risk-adjusted return profile and (ii) that clients/beneficiaries' preferences as regards ESG will be fully taken into account.

²⁸ See *Commission Staff Working Document, Impact Assessment (SWD(2018) 264 final, page 42)*.



Conclusion

18. Specifying the consideration of ESG factors in investment rules, governance requirements and risk management serves the purpose of avoiding different approaches across firms and Member States in the implementation of the current duties towards clients. It is therefore possible to conclude that the approach proposed in the current CP will increase consumer protection and ensure a level playing field among the financial market participants.
19. ESMA believes that the approach used in this CP to propose changes is able to strike a good balance between the need of harmonisation and the one of flexibility, while reaching the policy objectives of accomplishing the Commission’s mandate and providing clarity on ESG factors' integration and investor protection. ESMA believes that the suggested changes are proportionate in terms of costs for relevant entities as they require limited investment in ESG expertise, data and tools. The changes will achieve the intended objective of fulfilling the Commission’s mandate without imposing unnecessary burden on the relevant entities.
20. Therefore, the benefits of such approach are expected to be higher than the potential costs due to the adoption of harmonised criteria that would ensure more clarity and a coherent approach across the EU as regards the integration of ESG factors by the relevant entities, and this is expected to end up in more reliable and comparable ESG information for end-investors.

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.

Information requested	Firm response
Firm size (annual turnover in euro)	
Number of employees	
Firm complexity (low/medium/high)	
Expected costs from market research related to ESG factors (in euro)	
Expected IT costs related to ESG factors, initial and on-going (in euro)	Initial:
	On-going:



Expected training costs related to ESG factors (in euro)	Initial
	On-going
Other expected organisational costs related to ESG factors (in euro) – <i>please describe</i>	Initial
	On-going