Securities and Markets Stakeholder Group

Date: 6 March 2019
ESMA22-106-1683

ADVICE TO ESMA

ESMA Consultation Papers On integrating sustainability risks and factors in MIFID, the UCITS Directive and AIFMD.

I. Executive summary

In its comments applying to both consultation papers, the SMSG supports the work undertaken by ESMA.

The SMSG notes that the lack of agreed definitions and labels at the EU level is a substantial shortcoming and seriously hampers the implementation of a harmonized approach to sustainable finance. This should, however, not prevent firms from making progress in order to incorporate sustainability risks and factors, but should be taken into account by regulators and supervisors. In the absence of harmonized definitions, labels and taxonomy, the SMSG recommends that a public authority would publish a list of adequate labels.

The incorporation of ESG risks and factors is an evolving field and the SMSG therefore highlights (i) the need for supervisory convergence and (ii) the inclusion of a review clause in respect of regulation on sustainable finance.

The SMSG further deems it important that the proposed changes to the legislative framework should clarify how proportionality would be taken into account.

The SMSG considers that the regulatory approach should rely on firms designing an adequate compliance framework and makes several proposals in order to give guidance to firms. The SMSG finally makes a number of concrete comments and recommendations in response to the questions of the MiFID and UCITS/AIFMD consultation papers.

The SMSG would thus welcome the addition of several recitals, the publication of a list of relevant and adequate labels by a public authority and the inclusion of a review clause.

1. Overarching comments

1. The SMSG reiterates the comments made in its advice on Sustainable Finance of September 2018 (ESMA22-106-1301) and which are recalled in the ESMA CPs.

2. The SMSG considers that there is a strong political commitment across Europe to make good progress on integrating sustainability risks and factors in European financial legislation. While it seems that the EU is willing to make progress on its own without waiting for a global converging regime, coordination should be sought between the European Member States. Greater awareness of the importance of this issue is also required amongst global regulators as ultimately sustainability is a global issue and should be implemented globally. The SMSG notes that ESMA has performed an in depth work, particularly with regard to these two consultation papers, in a very tight timeframe. The SMSG is keen to support this move.

3. The SMSG also supports the efforts of ESMA and EIOPA to ensure consistency across sectors in respect of the integration of sustainability into the regulatory framework. The SMSG urges ESMA to continue such efforts after the consultation phase. Especially in areas such as product governance and suitability, where the regulatory framework of MiFID II and IDD is largely aligned, it is important that amendments to the regulatory framework to implement sustainability, do not lead to unnecessary differences.

4. The SMSG wishes to underline three characteristics and to make accordingly recommendations that should be taken into account in order to foster an adequate, ambitious and scalable regime.

a) The lack of agreed definitions and labels at the EU level is a substantial shortcoming and seriously hampers the implementation of a harmonized approach on sustainable finance. This should not prevent firms from making progress in order to incorporate sustainability risks and factors, but this should be taken into account by regulators and supervisors.

5. The lack of agreed definitions and labels at the EU level led to vivid and rich debates within the Group.

6. The SMSG is of the opinion that in order to prescribe conduct of business rules and to issue guidelines to financial services providers on how to integrate sustainability risks and factors into their activities, the EU needs one common and clear set of definitions and classifications to determine which are the ESG compatible (or not) economic activities. Only a clear and concise taxonomy that is built on a harmonised list of sustainability indicators - and designed by relevant experts (scientists such as physicists and biologists) - provides for a predictable and stable regulatory system which in turn is of utmost importance to foster private sector involvement in sustainable finance and to prevent harmful divergences, confusions and misconceptions. With its large and diverse scope, a taxonomy for E, S and G cannot be left to self-regulation or "best practices", but must be established through directly applicable, binding provisions at Union law level in order to avoid diverging application of law.

7. The SMSG would indeed have much preferred the adoption of a clear and appropriate taxonomy and labels before investment firms, institutional investors and assets managers were requested to disclose how they integrate sustainability risks in the investment decision-making process or advisory process.

8. A lack of common taxonomy has obviously several negative impacts: notably:

- It could lead to the development of products claiming incorrectly to be sustainable, leaving the investor with misleading guidance as to whether they incorporate environmental, social and corporate governance factors in their investment processes;

- A lack of clarity and/or multiplicity of approaches may also lead to misunderstandings, as well as frustrated expectations ("how" rather than "whether" factors are incorporated);

- It can also be a source of litigation between clients and investment firms/funds;

- The conjunction of the European pro-active approach on sustainable products and of multiple labels and uneven stages of development could undermine risk-assessment and comparability for investors, and create a risk of crowding or bubble effects within certain asset-classes;

- Beyond the product offerings, a plethora of labels and approaches as well as an uneven degree of maturity across Europe in respect of the social and governance factors may also have an impact on available skills and resources, training, and controls;

- As many labels are national and do not necessarily benefit from a framework of accepted common criteria, it prevents to a certain extent the development of pan-European products and the export of EU products into non EU jurisdictions.

9. The SMSG also considered that if the activity-based taxonomy and eco-labeling are critical to providing common standards for sustainability assessment, they are likely to be supplemented by consideration of other criteria such as company policy and practices which can be an important differentiator of sustainability (such as "best in class" analysis which incites ESG-friendly policies).

10. The SMSG noted that agreeing on a taxonomy will be a long journey and that as underlined by ESMA, the "Environmental" criteria are much more advanced than the "Social" and "Governance" ones. Meanwhile, the SMSG acknowledges that ESMA has been given a mandate by the Commission to come up with changes to the legislative framework, before an EU-wide harmonized taxonomy is in place. As extensively explained above, the SMSG is of the opinion that this is not the optimal way forward. If ESMA would nevertheless decide to deliver on its mandate and already put a number of requirements on investment firms and investment funds relating to sustainable finance before a harmonized taxonomy is in place, as the ESMA consultation paper suggests, the SMSG is of the opinion that in such a case it is necessary that a list of relevant and adequate labels should be published.

11. In order to achieve the objective of promoting a more sustainable economy through the financial sector, and in the absence of a harmonized taxonomy, publishing a list of relevant and adequate labels would indeed provide a hugely useful tool, particularly for smaller firms that do not have an extensive expertise in that domain but would nevertheless be obliged to comply with the sustainability standards which ESMA proposes to introduce and may be keen to be part of this trend and to maintain their competitive rank in their marketing efforts. It is important to take into account that ESG cover a number of concepts that are external to financial markets and thus, investment firms and investment advisors cannot be all supposed to handle them with technical knowledge in the absence of an official taxonomy or published list of relevant and adequate labels.

    Such a list would have to be published by a public authority, preferable an EU authority, subject to severe quality checks and a robust approval process.

12. The SMSG has noted that a two-step approach focusing firstly on the environmental factors and then on the social and governance factors of ESG may lead to an unbalanced capital allocation, i.e. to more investment in environmentally sustainable projects, leaving investments for social and governance-oriented initiatives on the side. Environmental and Social or Governance factors are not mutually exclusive; quite on the contrary, they tend to go hand in hand: namely, Governance risks may lead to social risks and/or environmental risks. However, in order to align the new rules on the currently existing environment, the European regulator and national competent authorities need to acknowledge the different stages of development of "E", "S" and "G". If ESMA would decide to proceed with the adaptation of the legislative texts before a taxonomy is adopted, the SMSG would welcome the addition of a recital to this end in order to encourage firms to incorporate progressively these three aspects, in a manner which is transparent to clients and investors. It is important that regulation directs issuers towards a progressive increase in the amount and quality of non-financial information disclosure, which in turn will promote a data-driven and transparent framework for investment firms, so as to be ready for the newer scenario of increased investor appetite for "sustainable" assets.

b) The incorporation of ESG risks and factors is an evolving field.

13. The SMSG supports the view taken by ESMA in its presentation of the Approach to the Commission's request that the integration of sustainability risks and factors is better done through a high-level principles-based approach for the reasons explained in the CPs. The SMSG is keen to see this approach reflected in the specific wording that would be used to amend the existing regulations. The contemplated amendments to the rules should reflect both a "top down" (ESMA driving the industry to enhance practices) and a "bottom up" approach (firms choosing to adapt as they deem adequate).

14. A clearer distinction between sustainability as a risk factor – relevant to all investments and financial institutions - and the "sustainability factors" – relevant to the products that have an ESG objective should be made.

15. In practice, whether relying or not on existing ESG market standards or labels, ESG product manufacturers' main challenge remains data availability. Manufacturers rely on a variety of external ESG data providers (which do not necessarily have harmonized methodologies and capture a mixed of quantitative and qualitative information from multiple sources, subject to their availability, such as tax declaration, social and economic assessment, income statements, questionnaires sent directly to companies or meetings organized with the different companies 'stakeholders etc.). The reality is that a limited number of companies issue clear, usable and standardized data on the sustainability of their activities and strategy/conduct. Although recognising that incorporating ESG considerations in the due diligence requirements is a positive step regarding the awareness of actors, the SMSG outlines that in the absence of a generally applicable and harmonized taxonomy, this can only be done successfully "where possible", i.e. when quality information from issuers is available.

16. From a broader standpoint and taking example on ESMA's work on the credit rating agencies CP, ESMA's recommendations should carefully avoid suggesting for instance that the consideration of ESG factors would systematically be relevant or more relevant than the consideration of classical financial factors and risks either to the portfolio management or to the client advice.

17. The SMSG highlights that for the purpose of risk assessment sustainability is a contributing factor which should be integrated into firms' existing risk analysis frameworks. Analysis of sustainability factors can improve or degrade the outlook for credit risk, liquidity risk, reputational risk etc which are already part of firms' risk analysis frameworks. ESMA should ensure that sustainability factors are appropriately integrated into risk analysis processes, but should not be prescriptive with regard to methodology.

18. The SMSG wishes to emphasize that the diversity of models and frameworks in the risk analysis process is the operational consequence of high level principles; diversity of approaches should be preserved so as to foster innovation and appropriateness in the manner of dealing with sustainably factors; this should be acknowledged in a recital. The SMSG discussed whether "E", "S" and "G" sustainability risks should be considered separately or together with other risks in a coherent set and concluded that, while there is no clear evidence that the former or the latter approach is better, optionality should be the rule.

19. As acting in the best interest of the investors is an overarching principle, the investor's perspective should also be the focus of attention when implementing sustainability considerations in MiFID2, the UCITS directive and AIFMD. The investor needs fair, clear and not misleading information about ESG considerations when making an investment decision. Some members highlighted that understanding investors ESG profile and preference is, at this stage of "market development" very difficult and likely not stable, while trying to quantify them seems almost impossible.

20. In order to take into account the above comments, it seems that

- firms should establish (and periodically review) policies and procedures in order to comply and they should explain how they consider that these policies and procedures fit with clients' and supervisors' expectations,

- best practices should be reviewed by NCAs and by ESMA periodically and at least 2 years after the implementation date in order to "enact" progress made.

21. While a "review clause" and avoiding too many "must have" would avoid creating regulatory risk and enable an evolution in practices, the use of recitals could provide the additional clarity and guidance needed for a "top down" perspective, for instance:
    - the SMSG noted that the available resource/ expertise / technical skills will increase over time, but are currently scarce compared to the scope and number of firms that would have to implement these changes. The SMSG would welcome an explicit reference in the draft RTS to the need to train relevant investment firm staff on ESG expertise, which requires time to implement on such a large scale.
    - While implicit in the CPs, the flexibility provided by outsourcing and external advice/support needs to be explicitly acknowledged, and encouraged, in order to allow smaller firms to be able to comply with the evolving market standards and European rules on sustainable finance. For instance, firms could explain why and how they have chosen an external provider, what is expected of them and how the service is reviewed/ assessed.
    - The principles-based approach on the one hand gives companies sufficient scope to implement the measures, but on the other hand carries the risk of "greenwashing". This makes it all the more important for companies to document the internally agreed framework, policies and procedures, measures taken and the set of indicators used to measure their effectiveness vis-à-vis the supervisory authorities and the clients and investors. Internal independent control / 2nd and 3rd "lines of defense" being in charge of monitoring and testing compliance with policies and procedures, a breach of these could potentially lead, if material and/or repeated enough, to a regulatory breach.

c) Proportionality

22. Smaller firms are very likely to struggle from a cost perspective with the impact of the new rules (access to resources, training, documentation, disclosures, controls and testing). Regulators and supervisors should be particularly cautious that smaller independent firms are not driven out. As proportionality is a cornerstone of the Commission's better regulation policy, the SMSG would recommend that ESMA reaffirms the proportionality principle and where possible clarifies in a recital for instance how proportionality could be applied depending on the size, nature, scale and complexity of their activities. For instance, the proportionality principle is reminded in the ESMA explanatory text in the AIFM/UCITS consultation, but is not reflected in the proposed amendments.

23. Application of proportionality should take into account that the expression "where relevant" is a cornerstone to adapt the new ESG requirements to the cases where it must be applied. "Where relevant" applies not only to specific products but also to clients' needs and demands.

24. Proportionality, together with flexibility should lead each investment firm to define the ESG criteria they apply, following an already existing label or not.

d) In the context discussed above, the ESMA Supervisory Convergence Work Programme is seen as an effective way to promote an evolutive and consistent approach of the integration of ESG factors and risks.

25. The SSMG notes that ESMA has identified Supervisory Convergence as a strategic priority for 2016-2020. Fostering a closer dialogue between supervisors across the EU on their local respective market practices, regulatory approaches and supervisory findings relating to sustainability would enable to make progress towards “consistent best standards” together with maintaining proportionality. While further guidance will be welcome in order to reduce regulatory uncertainty and achieve convergence, the SMSG stresses the importance of an adequate public consultation before these are published.

2. MIFID II Consultation Paper (ESMA35-43-1210)

Question 1: Do you agree with the suggested approach and the changes to Art. 21 of the MiFID II Delegated Regulation?

The SMSG has two comments in regard of the new draft paragraph in Article 21.

1. First, the new paragraph states “where ESG considerations are relevant for the provision of investment services to clients…”. The SMSG advises ESMA to specify in a recital the investment services to which this rule applies. It should be noted that the consultation mainly focuses on investment advice and portfolio management (as they are defined and specified by MIFID).

2. Second, the new paragraph should be put before the current last paragraph on proportionality (in regard of the nature, scale and complexity of the business and the nature and range and activities). By placing the new paragraph before the proportionality paragraph, the proportionality paragraph would also apply to the new requirement in regard to sustainability.

Question 2: Do you agree with the suggested approach and the changes to Art. 23 of the MiFID II Delegated Regulation?

3. We welcome ESMA’s statement in para 8 of the CP that “singling out sustainability risks (…) is unnecessary to achieve the Commission’s objectives and would be disproportionate”. We note that from a risk management perspective, sustainability factors do not create an additional separate risk, but rather create variation into existing risks already under management such as credit, market, operational or reputational risks. Accordingly, mandating a consideration of sustainability risk as a standalone risk would not be appropriate.

4. As a matter of fact, the modification contemplated by ESMA seems quite demanding (for instance it does not differentiate between E, S and G) and its practical implementation is likely to vary across jurisdictions. For these reasons, and as explained in the second section (b) of the overarching comments, the SMSG recommends to change the new text of article 23 as follows: “In doing so, investment firms should design an adequate framework with a view to integrating the ESG risks and factors, where appropriate and relevant”. Investment firms should be to explain this framework to their internal governance and supervisor (or put it at the disposal of the supervisor for review).

5. The SMSG understands that firms are required to adopt an internal framework designed to incorporate ESG risks and factors where relevant and to ask their clients about their preferences but they are not required to offer products or investment advices/ portfolio management that are ESG “driven”; this might be recalled in a recital.

6. The SMSG recommends that the terms “where relevant” be included in the added paragraph of Article 23, in order to acknowledge that not all products have an ESG focus.

Question 3: Do you agree with the suggested approach and new recital on conflicts of interests?

7. In MIFID, the requirement to manage conflicts of interest is generic and conflicts of interest should encompass all types of activities. The SMSG supports the wording of the proposed recital, and suggests to explicitly add the examples mentioned in paragraph 13 of the CP in the recital. Some members of the SMSG would prefer that ESMA goes further than a recital and would add an additional bullet on ESG in article 33 of the MiFID II Delegated Regulation.

Question 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?

8. An analysis of the existing labels is not within the remit of the SMSG. Please refer to the extensive reservations of the SMSG in respect of the use of non-harmonized market standards or labels, mentioned in paragraphs 5-12 of this advice.

9. P. 14, para 8 of the CP: The SMSG considers that from a legal certainty standpoint, no rule or definition should be front-run: the reference to the "preparatory work (…) published by the Commission" and to 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" should not become binding before …it is binding. It should be clarified that firms are invited to consider the ongoing work rather than mandate the reference to these definitions.

Questions 6-9 relating to product governance

10. P. 14 para 9:

    The SMSG is of the opinion that the target market is indeed the best approach to integrate a product's ESG considerations, as long as this leaves sufficient flexibility for proportionate and pragmatic implementation in practice in the type of ESG information investment firms indicate for each product they manufacture and/or distribute:

    a) All products do not have a sustainability objective; if products do not have a sustainability objective, this should be mentioned to investors in a simple and clear manner.

    b) Making a clear distinction between the different ESG dimensions is not necessarily appropriate for all types of investment vehicles and strategies. The assessment process is very dependent on the granularity and sophistication of available ESG data, which can make such an exercise highly complex and burdensome.

    c) The assessment requirement should be limited to products that are manufactured with a specific ESG investment objective. Given the required level of sophistication of sustainability filters and data to create an ESG product, it would not be appropriate or proportionate to require investment firms to assess the ESG characteristics of non-ESG investment products.

    d) In addition, the assessment requirement should not be retroactive at the point of implementation, but should only apply to newly created products or to the modification of existing products. If ESMA's interpretation would be otherwise, an appropriate period of time should be provided in order to adequately remediate the stock of products. This should then be clarified at least in a recital.

e) To the extent that the suitability requirement and target market definitions would be applicable prior to the finalization of the taxonomy on sustainable activities, standards to describe and integrate ESG preferences into ESG products' target market should avoid being overly prescriptive, in order to avoid having to bear a double implementation burden (which would carry significant IT, compliance and project management resources) before and after publication of the taxonomy. This flexibility should also allow investment firms to integrate sustainability-enhancing behavior that may not be covered by the taxonomy on sustainable activities.

11. P. 15 para 15:

The clients with ESG preferences may also have other complementary preferences that are not necessarily ESG-related. In the case where a product does not have ESG characteristics while the client has certain ESG preferences, the client may still wish to trade in that product if the product matches his characteristics and other complementary preferences. Therefore, the SMSG suggest a 2-steps approach offering a clear framework to such a situation to protect investors.

- Step 1: The firm should send a clear statement to the client that the product meets all the clients' characteristics (type, knowledge and experience, risk tolerance, financial situations and non-ESG related objectives and needs) except ESG preferences.

- Step 2: The client responds to the firm via recorded phone call, e-mails or other media whether he wishes to trade in the product even if the product in question does not meet his ESG preferences.

However, the above should be seen as illustrative rather than mandatory; the firms should specify in their internal policies and procedures how they intend to comply with the integration of sustainability in their product governance and ensure that what has been specified is indeed adhered to, traced and monitored, and as the case may be, according to experience and market best practices/clients requests, how the framework will evolve.

Question 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?

12. An analysis of the existing labels is not within the remit of the SMSG. Please refer to the extensive reservations of the SMSG in respect of the use of non-harmonized market standards or labels, mentioned in paragraphs 5-12 of this advice.

Question 11: Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines?

13. P. 23, para 11: The SMSG agrees with ESMA that ESG considerations are to contribute as an additional aspect to the other "classical" suitability criteria and do not outweigh their relevance.

3. UCITS and AIFMD Consultation Paper (ESMA34-45-569)

Question 3: Do you see merit in expressly requiring or elaborating on the designation of a qualified person within the authorized entity responsible for the integration of sustainability risks and factors?

14. The SMSG notes that

- each organization is different and should be able to carry out their own meaningful set up depending on the size, nature, scale and complexity of their activities,
- this requirement can also be challenged from a proportionality standpoint,
- the integration of sustainability risks and factors should be part of the clear definition of roles and responsibilities within a firm.

15. Nevertheless, the SMSG agrees that in order notably to ensure the awareness of the senior management and leadership on this sensitive topic, a person or function responsible for the integration of sustainability risks and factors should be identified. If such a requirement is introduced, ESMA should made clear that this requirement should be applied proportionally: this person should not be required to have an “established” expertise and should not dedicate 100% of his or her time to this task. The term “qualified” should therefore be deleted.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

Adopted on March 6th, 2019
[signed]
Veerle Colaert
Chair
Securities and Markets Stakeholder Group