

CONSULTATION RESPONSE

ESMA CONSULTATION PAPER ON TECHNICAL ADVICE ON THE INTEGRATION OF SUSTAINABILITY RISKS AND FACTORS IN THE DELEGATED ACTS UNDER AIFMD AND UCITS DIRECTIVE

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An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

INTRODUCTION

ABOUT THE PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2200 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$83 trillion in assets under management. Of these, over half are based in Europe.

The PRI works with policy makers, regulators, investors and stakeholders to improve the sustainability of the financial system and address systemic market risks through policy change. The PRI has experience of responsible investment public policy reform in multiple markets, including the UK, Europe, US and China. The PRI was an observer to the European Commission's [High Level Expert Group on Sustainable Finance](#) and is leading the taxonomy working group of the [Technical Expert Group on Sustainable Finance](#).

SUMMARY OF RESPONSE

The PRI supports many aspects of the proposed technical advice from ESMA. **However, the PRI strongly recommends that the draft technical advice also provide clarity on investor duties, as set out in Article 14(1) of the UCITS Directive and Article 12(1) of AIFMD.**

The PRI strongly supports action by EU institutions to clarify the relationship between investor duties and sustainability. Since 2005¹, a growing body of analysis and opinion has demonstrated that failure to consider these issues in investment practice is a failure of investor's duties. The PRI's 2015 report, [Fiduciary Duty in the 21st Century](#), recognised that outdated perceptions of fiduciary duty and ESG and lack of regulatory clarity contributed to the lack of systematic ESG integration by investors. This was echoed in the 2016 consultation on long-term sustainable investment² and the 2017 consultation on the Capital Markets Union mid-term review³, as well as the recommendations of the [High Level Expert Group on Sustainable Finance](#) (HLEG). However, investors are not yet systematically integrating these issues. The PRI finds that ambiguity around investor duties has been a key barrier. Clarification of these duties will address a critical market issue, encourage consistent and systematic ESG integration and fully align with the aims and intents of the European Commission's Action Plan on Sustainable Finance.

This paper draws from research projects on fiduciary duty and emerging practices in relation to ESG and equity and credit risk analysis. We would welcome the opportunity to share further details on this research with ESMA.

¹ Examples include: UNEP FI and Freshfields Bruckhaus Deringer, [A legal framework for the integration of environmental, social and governance issues in institutional investment](#), 2005. UK Law Commission [Fiduciary Duties of Investment Intermediaries](#) (2014) and [Pension Funds and Social Investment](#), 2017.

² This concluded that 'the large majority of contributors, in particular institutional investors and NGOs, argued that fiduciary duty, that is, the duty of investors and asset managers to act in the best interest of the beneficiary (future pensioners) or the client (retail or institutional investors) was not clear enough and could therefore be used as an excuse for not considering ESG matters in investment decisions'

³ This proposed 'clarification that fiduciary duties of asset owners and asset managers includes integrating environmental, social and governance (ESG) considerations into decision making'

RESPONSE TO DETAILED QUESTIONS

1. OVERVIEW

Question to stakeholders

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

The six Principles for Responsible Investment refer to “Environmental, Social and Governance” (ESG) issues and this remains the PRI’s preferred terminology to describe factors which should be incorporated into financial analysis. The PRI understands ESG risks to be those that are influencing, or are likely to influence, the risk and return characteristics of an investment. ESG risks and opportunities are dynamic, evolving in response to changing scientific understanding and societal expectations. We note that as well as risks, ESG can also be a framework for evaluating opportunities and we recommend that ESMA incorporate this into the draft technical advice.

The PRI’s ESG in Credit Risk initiative, launched in 2016, has extensively analysed the role of ESG in credit risk analysis. In February 2019, the PRI launched a report which provided a conceptual framework for ESG risks, based on roundtables with credit analysts. This has been specifically developed for credit analysis, so should not be read as automatically applicable to other asset classes.

Type	Event-driven (e.g. flooding)	Trend-driven (e.g. climate change)	Policy-driven (e.g. regulatory changes)
Level	Issuer (e.g. management contract)	Issue (e.g. bond duration and pricing)	Portfolio (e.g. measuring top-down risk/strategic allocation).
Breadth	Macro (e.g. demographics)	Sector level (e.g. Auto and vehicle emissions tests)	Micro (e.g. fraud/litigation)
Timing	Present (e.g. existing carbon controls)	Emerging (e.g. Regulatory plans to curb plastic packaging)	Potential (e.g. technology and consumer preference changes).

For further information, please see: <https://www.unpri.org/credit-ratings/esg-credit-risk-and-ratings-part-3-from-disconnects-to-action-areas-/3996.article>

The PRI provides an indicative list of environmental, social and governance issues to aid investors in the early stages of implementation. This should not be read as exhaustive or complete, rather it is a tool to help investors begin to think about ESG.

Environmental (E)

Issues relating to the quality and functioning of the natural environment and natural systems. These include: biodiversity loss; greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric

ozone depletion, changes in land use, ocean acidification and changes to the nitrogen and phosphorus cycles.

Social (S)

Issues relating to the rights, well-being and interests of people and communities. These include: human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities, activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons.

Governance (G)

Issues relating to the governance of companies and other investee entities. In the listed equity context these include: board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its other stakeholders. This category may also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented. In the unlisted asset classes governance issues also include matters of fund governance, such as the powers of Advisory Committees, valuation issues, fee structures, etc.

2. ORGANISATIONAL REQUIREMENTS

Draft Technical Advice

Article 4 of the Commission Directive 2010/43/EU on "General Requirements on Procedures and Organisation" to be amended as follows:

Member States shall require management companies to comply with the following requirements:

- (a) to establish, implement and maintain decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities;
- (b) to ensure that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;
- (c) to establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the management company;
- (d) to establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the management company as well as effective information flows with any third party involved;
- (e) to maintain adequate and orderly records of their business and internal organisation.

Member States shall ensure that management companies take into account the nature, scale and complexity of the business of the management company, and the nature and range of services and activities undertaken in the course of that business. **Member States shall ensure that**

management companies take into account sustainability risks and factors when complying with the requirements laid down in the first subparagraph.

Article 5 of the Commission Directive 2010/43/EU on “Resources” to be amended as follows:

5. Member States shall ensure that for the purposes laid down in paragraphs 1, 2 and 3, management companies take into account the necessary resources and expertise for the effective integration of sustainability risks and factors.

Article 9 of the Commission Directive 2010/43/EU on “Control by Senior Management and Supervisory Function” to be amended as follows:

2. The management company shall ensure that its senior management:

[...]

g) is responsible for the integration of sustainability risks and factors.

Article 22 of the Commission Delegated Regulation (EU) 231/2013 on “Resources” to be amended as follows:

3. For the purposes of paragraph 1, AIFMs should take into account the necessary resources and expertise for the effective integration of sustainability risks and factors.

Article 57 of the Commission Delegated Regulation (EU) 231/2013 on “General Requirements” to be amended as follows:

1. AIFMs shall:

(a) establish, implement and maintain decision-making procedures and an organisational structure which specifies reporting lines and allocates functions and responsibilities clearly and in a documented manner;

(b) ensure that their relevant persons are aware of the procedures to be followed for the proper discharge of their responsibilities;

(c) establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM;

(d) establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the AIFM and effective information flows with any third party involved;

(e) maintain adequate and orderly records of their business and internal organisation.

AIFMs shall take into account the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business. **AIFMs shall take into account sustainability risks and factors when complying with the requirements laid down in the first subparagraph.**

Article 60 of the Commission Delegated Regulation (EU) 231/2013 on “Control by the governing body, senior management and supervisory function” to be amended as follows:

2. An AIFM shall ensure that its senior management:

[...]

(i) is responsible for the integration of sustainability risks and factors.

Questions to stakeholders

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

The PRI welcomes the proposed amendments to the general requirements, resources and control sections of the delegated acts. A principles-based approach will provide clarity that ESG risks and opportunities should be considered, while giving flexibility to investors to integrate this into existing procedures and systems. We note that investors have adopted a wide range of techniques for integration of ESG risks and opportunities. For further information, please see the ESG Integration Framework⁴, released by the PRI and the CFA Institute in 2018 which collates integration techniques used by investment practitioners around the globe.

We recommend that the term “ESG risks and opportunities” be used instead of “sustainability risks and factors”.

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

See response to Q2.

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

Yes. The PRI recommends the following additional amendments:

- a) Article 22 of Commission Directive 2010/43/EU (UCITS delegated directive) be amended to provide explicit clarification of the relationship between ESG and investor duties as articulated in Article 14(1)a-b of the UCITS Directive, and;
- b) Article 17 of Commission Delegated Regulation 231/2013/EU (AIFMD delegated regulation) be amended to provide explicit clarification of the relationship between ESG and investor duties as articulated in Article 12(1)a-b of AIFMD.

The following language is proposed:

Member States shall require that management companies:

- *take into account ESG risks and opportunities, consistent with the investment timeframe of the end investor, in investment processes and stewardship activities.*

⁴ <https://www.unpri.org/the-esg-integration-framework/3722.article>

- *proactively seek to understand the ESG preferences of their end investors and incorporate those preferences into their investment decision-making and stewardship activities where possible.*

Rationale

The Commission request for technical advices (July 2018) requested ESMA’s advice on the delegated acts under UCITS, AIFMD and MiFID II “in order to explicitly require the integration of 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”. We understand these to be the ‘fiduciary’ duties expressed as follows:

UCITS: Article 14(1) of Directive 2009/65/EC (hereafter UCITS) establishes the requirement for Member States to draw of rules of conduct which implement core elements of “fiduciary” duties, ensuring that the UCITS management company:

- (a) *Acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market;*
- (b) *acts with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market;*
- (c) ...

Article 14(2)a empowers the Commission, via delegated acts, to “establish appropriate criteria for acting honestly and fairly and with due skill, care and diligence in the best interests of the UCITS”. This is implemented via Article 22 of Commission Directive 2010/43/EU.

AIFMD: Article 12(1) of Directive 2011/61/EU (hereafter AIFMD) establishes the requirement for Member States to ensure that AIFMs:

- (a) *act honestly, with due skill, care and diligence and fairly in conducting their activities;*
- (b) *act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market;*
- (c) ...

Article 12(3) empowers the Commission, via delegated acts, to specify the criteria used by competent authorities to assess whether AIFMs comply with these obligations. This is implemented via Article 17 of Commission Delegated Regulation 231/2013/EU.

The PRI strongly supports action by EU institutions to clarify the relationship between investor duties and ESG issues. Since 2005⁵, a growing body of analysis and opinion has demonstrated that failure to consider these issues in investment practice is a failure of investor’s duties. The PRI’s 2015 report, [Fiduciary Duty in the 21st Century](#), recognised that outdated perceptions of fiduciary duty and ESG and lack of regulatory clarity contributed to the lack of systematic ESG integration by investors.

⁵ Examples include: UNEP FI and Freshfields Bruckhaus Deringer, [A legal framework for the integration of environmental, social and governance issues in institutional investment](#), 2005. UK Law Commission [Fiduciary Duties of Investment Intermediaries](#) (2014) and [Pension Funds and Social Investment](#), 2017.

This was echoed in the 2016 consultation on long-term sustainable investment⁶ and the 2017 consultation on the Capital Markets Union mid-term review⁷, as well as the recommendations of the [High Level Expert Group on Sustainable Finance](#) (HLEG).

The PRI was an observer to the HLEG and contributed to the recommendations on reforming investor duties, governance and risk management. The HLEG analysis identified several critical dimensions to clarify:

- Key investment activities, including investment strategy, risk management, asset allocation, governance and stewardship should integrate a broad range of value-drivers including ESG factors.
- There should be greater alignment with the time horizon of the end beneficiary or policy-holder.
- Investors should proactively seek to understand the ESG interests and preferences of their clients, members or beneficiaries and disclose whether, and how, these have been taken into account.
- Stewardship is an essential element in fulfilling investor duties.

However, investors are not yet systematically integrating these issues. The PRI finds that ambiguity around investor duties has been a key barrier. To that effect, while the PRI supports the proposed technical advice from ESMA regarding ESG issues and general requirements, resources, control and supervision, the PRI strongly recommends that the core duties are also clarified to avoid creating inconsistency and to fully align with the aims and intents of the Action Plan on Sustainable Finance.

The PRI also notes the importance of consistency across sectors. The draft technical advice provided by EIOPA on amendments to the Solvency II delegated regulation provide explicit clarification that ESG risks should be considered as part of the exercise of the prudent person principle. To ensure consistency, equivalent clarification should be provided to UCITS and AIFMD firms (as well as those regulated under MiFID II which we cover in a separate consultation response). The PRI strongly welcomed this proposal from EIOPA, while also proposing some improvements to the language consistent with our recommendations above.

In addition, the PRI recommends that disclosure requirements are also updated to require disclosure on the integration of ESG issues into governance and risk management. This will be critical to ensure that regulators and clients have adequate information and to understand and assess investor practices.

⁶ This concluded that 'the large majority of contributors, in particular institutional investors and NGOs, argued that fiduciary duty, that is, the duty of investors and asset managers to act in the best interest of the beneficiary (future pensioners) or the client (retail or institutional investors) was not clear enough and could therefore be used as an excuse for not considering ESG matters in investment decisions'

⁷ This proposed 'clarification that fiduciary duties of asset owners and asset managers includes integrating environmental, social and governance (ESG) considerations into decision making'

3. OPERATING CONDITIONS

Draft Technical Advice

New recital 17 (bis) to be added to Commission Directive 2010/43/EU as follows:

When identifying the types of conflicts of interest whose existence may damage the interests of a UCITS, management companies should include those that may arise in relation to the integration of sustainability risks and factors.

Article 23 of the Commission Directive 2010/43/EU on “Due Diligence Requirements” to be amended as follows:

1. Member States shall require management companies to ensure a high level of diligence in the selection and ongoing monitoring of investments, in the best interests of UCITS and the integrity of the market.
2. Member States shall require management companies to ensure they have adequate knowledge and understanding of the assets in which the UCITS are invested.
3. Member States shall require management companies to establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the UCITS are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS.
4. Member States shall require management companies when implementing their risk management policy, and where it is appropriate after taking into account the nature of a foreseen investment, to formulate forecasts and perform analyses concerning the investment’s contribution to the UCITS portfolio composition, liquidity and risk and reward profile before carrying out the investment. The analyses must only be carried out on the basis of reliable and up-to-date information, both in quantitative and qualitative terms. Management companies shall exercise due skill, care and diligence when entering into, managing or terminating any arrangements with third parties in relation to the performance of risk management activities. Before entering into such arrangements, management companies shall take the necessary steps in order to verify that the third party has the ability and capacity to perform the risk management activities reliably, professionally and effectively. The management company shall establish methods for the on-going assessment of the standard of performance of the third party

5. Member States shall require that management companies take into account sustainability risks and factors when complying with the requirements set out in paragraphs 1 to 4.

New recital 48 (bis) to be added to Commission Delegated Regulation (EU) 231/2013 as follows:

When identifying the types of conflicts of interest whose existence may damage the interests of an AIF or its investors, AIFMs should include those that may arise in relation to the integration of sustainability risks and factors.

Article 18 of the Commission Delegated Regulation (EU) 231/2013 on “Due Diligence” to be amended as follows:

1. AIFMs shall apply a high standard of diligence in the selection and ongoing monitoring of investments.
2. AIFMs shall ensure that they have adequate knowledge and understanding of the assets in which the AIF is invested.
3. AIFMs shall establish, implement and apply written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, the investment strategy and, where applicable, the risk limits of the AIF.
4. The policies and procedures on due diligence referred to in paragraph 3 shall be regularly reviewed and updated.
- 5. AIFMs shall take into account sustainability risks and factors when complying with the requirements set out in paragraphs 1 to 3.**

Questions to stakeholders

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

The PRI supports the high-level, principles-based approach given the dynamic nature of ESG risks and opportunities and the diversity of approaches in the market.

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

As above, the PRI supports the high-level, principles-based approach. Additional guidance from ESMA would be valuable to help build capacity in the market.

Q7: Do you agree with the proposed inclusion of recitals relating to conflicts of interest? Should the technical advice cover specific examples? If so, what would be specific examples of conflicts of interests that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?

No response.

Q8: Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

Yes. The PRI proposes that the term “ESG risks and opportunities” be used.

4. SUITABILITY

Draft Technical advice

Article 38 of the Commission Directive 2010/43/EU on “Risk Management Policy” to be amended as follows:

1. Member States shall require management companies to establish, implement and maintain an adequate and documented risk management policy which identifies the risks the UCITS they manage are or might be exposed to.

The risk management policy shall comprise such procedures as are necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market, liquidity, **sustainability** and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for each UCITS it manages.

Article 40 of the Commission Delegated Regulation (EU) 231/2013 on “Risk Management Policy” to be amended as follows:

2. The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity, **sustainability** and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages.

Questions to stakeholders

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

Yes. In line with the recommendations of the HLEG on sustainable finance, we support the explicit inclusion of language to draw attention to the importance of ESG risks within existing risk management processes.

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

While some investors do integrate ESG risks and opportunities, the market is still evolving rapidly. Further guidance from ESMA on best practices would be welcome.

As we noted in question 1, the PRI's ESG in Credit Risk initiative, launched in 2016, has extensively analysed the role of ESG in credit risk analysis. In February 2019, the PRI launched a report which provided a conceptual framework for ESG risks, based on roundtables with credit analysts. This has been specifically developed for credit analysis, so should not be read as automatically applicable to other asset classes.

Type	Event-driven (e.g. flooding)	Trend-driven (e.g. climate change)	Policy-driven (e.g. regulatory changes)
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Timing	Present (e.g. existing carbon controls)	Emerging (e.g. Regulatory plans to curb plastic packaging)	Potential (e.g. technology and consumer preference changes).

For further information, please see: <https://www.unpri.org/credit-ratings/esg-credit-risk-and-ratings-part-3-from-disconnects-to-action-areas-/3996.article>

Q11: Do you see merit in amending risk management provisions relating to the regular review of risk management policies and systems in order to more specifically refer to elements related to sustainability risks (e.g. quality of the arrangements, processes, techniques and data used, need for authorised entities to highlight the limitations, and demonstrate the absence of available alternatives)?

As above, we would welcome additional guidance from ESMA.

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

No.