Principles for Responsible Investment

CONSULTATION RESPONSE

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

February 2019

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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 21(1) of MiFID II.**

The PRI strongly supports action by EU institutions to clarify the relationship between investor duties and sustainability. Since 2005[1], 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 The PRI's 2015 report, Fiduciary Duty in the 21st Century, recognised that outdated perceptions of fiduciary duty and ESG and lack of regulatory clarity contributed to the lack of systematic ESG integration by investors.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 investment[2] and the 2017 consultation on the Capital Markets Union mid-term review[3], 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.

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[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

2. ORGANISATIONAL REQUIREMENTS

Draft Technical Advice

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.

Questions to stakeholders

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.

The PRI welcomes the intent of the proposed changes to the general organisation requirements. To ensure consistency across sectors, the PRI recommends that ESMA align amendments to Article 21(1) of the MiFID II Delegated Regulation with the proposed changes to Article 57 of the Commission Delegated Regulation (EU) 231/2013 (AIFMD). The PRI therefore recommends that the amendment be changed to "Investment firms shall take into account ESG risks and opportunities when complying with the above requirements."

Q2: Do you agree with the suggested approach and the changes to the Article 23 of the MiFID II Delegated Regulation on 'risk management'? Please state the reasons for your answer.

The PRI welcomes the introduction of specific language in Article 23 of the MiFID II Delegated Regulation to remove ambiguity and draw attention to the need to assess these risks. The high-level, principles-based approach is appropriate given the dynamic nature of ESG risks and opportunities. We note that risks originating from sustainability factors can and should be integrated into existing systems and processes and therefore welcome the proposal to include this as part of the overall risk management framework. For investors who are at an early stage of development on ESG risks and opportunities, additional guidance and best practice examples would be beneficial.

We would like to raise one aspect of ESMA's analysis on risk management (page 9 of the consultation paper), which discusses the development of the unified classification system, or taxonomy. The PRI recognises that the taxonomy will be a critical tool for investors and issuers. However, if developed as per the draft regulation, it will assess the contribution that activity seeks to make to environmental objectives, but make no judgement on the riskiness of that investment. We therefore see it as a policy tool to drive capital towards sustainable outcomes, rather than a tool for integration of ESG risks into investment processes[4].

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?

No response.

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.

Yes. The PRI recommends additional language in Commission Delegated Regulation 2017/565/EU (MiFID II delegated regulation) to provide explicit clarification of the relationship between sustainability and investor duties as articulated in Article 24(1) of Directive 2014/65/EU (MiFID II directive). We recommend the following language:

- *Investment firms shall take into account Environmental, Social and Governance (ESG) risks and opportunities, consistent with the investment timeframe of the clients, in investment processes and stewardship activities.*
- *Investment firms shall proactively seek to understand the ESG preferences of their client and shall incorporate those preferences into their investment decision-making and their stewardship activities where possible.*

[4] The final report of the High Level Expert Group on Sustainable Finance noted that the reform of Europe's financial markets had a 'dual imperative' – the full integration of ESG risks and opportunities, and increasing the contribution that the financial system makes to ESG outcomes. Both are necessary, but require clear distinction and differing policy tools.

Rationale

The Commission request for technical advices (July 2018)[5] seeks ESMA's technical advice 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" in MiFID II, AIFMD and UCITS. We understand these duties to be the 'fiduciary duties' expressed in Article 24(1) of Directive 2014/65/EU:

> *Member States shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.*

Article 24(13) empowers the Commission, via delegated acts, to "*ensure that investment firms comply with the principles set out in this Article when providing investment or ancillary services to their clients"*. This is implemented via Article 65 of Commission delegated regulation 2017/565/EU.

At a minimum, the clarification should cover the following investment services and ancillary activities:

- Portfolio management (annex I, section A, 4);
- Investment advice (annex I, section A, 5);
- Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments (annex I, section B, 5).

The PRI strongly supports action by EU institutions to clarify the relationship between investor duties and sustainability. Since 2005[6], 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 investment[7] and the 2017 consultation on the Capital Markets Union mid-term review[8], as well as the recommendations of the High Level Expert Group on Sustainable Finance (HLEG). 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 sustainability factors.

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[5] Commission Request for Technical advice on the integration of sustainability risks and factors

[6] 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.

[7] 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'

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

- There should be greater alignment with the time horizon of the end beneficiary or policy-holder.
- Investors should proactively seek to understand the sustainability 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[9]. 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 organisational requirements, the **P**RI 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 sustainability risks should be considered as part of the exercise of the prudent person principle. To ensure consistency, equivalent clarification should be provided to MiFID II (as well as those regulated under UCITS and AIFMD firms 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 sustainability 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.

4. SUITABILITY

Draft Technical advice to amend 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

[9] Some examples of evidence include:

- The Global Sustainable Investment Alliance estimated that around $2.2 trillion AUM in Europe was managed using an ESG integration strategy, less than 10% of the funds managed by European fund managers (EFAMA estimates that European fund managers manage $26.4 trillion (22.8 trillion Euro)).
- PRI / CFA institute surveyed 58 investors, 74% of respondents were European, most were fund managers. Of these:
  - 83% say portfolio managers and analysts do not regularly include material ESG issues in equity analysis
  - 75% say portfolio managers and analysts do not regularly include material ESG issues in credit analysis
- ShareAction study of 40 European asset managers which finds a very wide variation between leaders and laggards on ESG (source). This report also concluded legal clarity around ESG was necessary.

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 risk, ...) 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 obligations. 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 Directive which may, for example, change their nature into shares).

Questions to stakeholders

Q5: 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.

Market standards and labels can be a valuable communication tool. However, we note that most labels focus on the ESG characteristics of the investments rather than the investor's processes regarding ESG. The PRI recommends that the suitability assessment criteria reflect the variety in existing market practices regarding ESG. Broadly, these can be grouped into:

- Incorporation of ESG issues into investment decision-making. Typically, this would involve one or more of the following methods:
  - Integration of ESG issues into investment analysis[10].
  - Screening (removing selected stocks or instruments from the investment universe based on ESG characteristics).
  - Environmental or social themed investing, selecting assets which contribute to specific challenges.
- Active ownership of assets (including engagement and voting shares, where appropriate).

Q6-9: No answer.

Q10: Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines? If not, do you have any suggestions for developing a more detailed approach with regard to (a) the collection of information from clients and (b) the assessment of ESG preferences with the assessment of suitability?

In line with the recommendations of the HLEG on sustainable finance, we support the explicit inclusion of language to draw attention to the importance of proactively seeking to understand clients'

[10] For further information, please see the ESG Integration Framework (PRI, 2018).

ESG preferences. In the draft technical advice, we recommend that ESMA be clear throughout where the regulation is applying to ESG risks and opportunities (which should be incorporated into the investment strategy and stewardship activities of an investor acting in the best interests of the client) and ESG preferences (which should be incorporated to the extent possible). The term “sustainability considerations” could be interpreted to refer to either category, so we recommend that ESMA adopt the terms “ESG risks and opportunities” and “ESG preferences” for consistency.

The taxonomy may be a useful tool in the suitability assessment, but the PRI does not recommend that investors be required to ask questions which are consistent with the taxonomy in all cases. It is expected that the eventual taxonomy will be a technical framework designed for an institutional investor audience which may prove too technical to aid discussions with some clients.

Finally, for consistency, it is important to ensure that the language used accurately reflects that the taxonomy, as conceived under the existing regulation, provides a framework for assessing the sustainability of <u>economic activities</u> rather than investment products (as stated in article 28).

Q7: 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.

As per question 10, the PRI recommends that the criteria should reflect the variety in existing market practices regarding ESG. Broadly, these can be grouped into:

- Incorporation of ESG issues into investment decision-making. Typically, this would involve one or more of the following methods:
  - Integration of ESG issues into investment analysis[11]
  - Screening (removing selected stocks or instruments from the investment universe based on ESG characteristics).
  - Environmental or social themed investing, selecting assets which contribute to specific challenges.
- Active ownership of assets (including engagement and voting shares, where appropriate).

Q7: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

The proposed amendments to paragraph 70 refer to “ESG considerations”. We support the clarification but it is important to distinguish between ESG risks and opportunities and a beneficiary’s ESG preferences. We therefore recommend the following amendment to paragraph 70:

Firms should adopt robust and objective procedures, methodologies and tools that allow them to appropriately consider the different characteristics (**including, where relevant, ESG** ~~considerations~~ **<u>characteristics of the investment approach</u>**) and relevant risk factors (such as credit risk, market

[11] For further information, please see the ESG Integration Framework (PRI, 2018).

risk, liquidity risk**, ESG risk**...) 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 obligations. 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 Directive which may, for example, change their nature into shares).