ESMA’s technical advice to the European Commission on integrating sustainability risks and factors in MiFID II, the UCITS Directive and AIFMD. June 2019.

Background

In March 2018, the European Commission (EC) published its Action Plan for Financing Sustainable Growth, which has three main objectives: (1) reorient capital flows towards sustainable investment, (2) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and (3) foster transparency and long-termism in financial and economic activity.

Subsequently, in May 2018, the EC presented a draft of legislative measures with three basic proposals: 1) establishing a unified European Union (EU) taxonomy; 2) improving disclosure requirements on how institutional investors integrate environmental, social and governance factors in their risk processes and 3) creating a new category of benchmarks.

In July 2018, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) received a mandate from the EC to provide technical advice, in a consistent and concerted manner, on the integration of sustainability risks and sustainability factors in the following legislation: Directive on undertakings for collective investment in transferable securities (UCITS), Solvency II Directive, Insurance Distribution Directive, Alternative Investment Fund Managers Directive (AIFMD) and Markets in Financial Instruments Directive (MiFID II).

As a result, ESMA published two consultation documents (one for MiFID II and one for UCITS and AIFMD) in December 2018 in order to collect information and reactions from the industry and other market agents to the proposals made. It also held a public hearing in February 2019 aimed at the industry to obtain additional information.

Public consultation: content, responses received and their analysis

Content

In accordance with the EC’s mandate, the consultation document referred to the integration of sustainability risks and factors in the following areas: organisational requirements, risk management, conflicts of interest and product governance.

The EC’s mandate with regard to UCITS and AIFMD referred to including sustainability criteria in the provisions of both directives relating to organisational requirements, operating conditions and risk management.

Responses received

For the MiFID II consultation document, 69 responses were received, while 60 were received for the document jointly addressing AIFMD and UCITS. In both documents, the Securities and Markets Stakeholders Group (SMSG) participated by providing its recommendations to the proposals made by ESMA.

Analysis of responses received

On a general basis and for both consultation documents, the following general comments may be made:

1. Most of the respondents to the public consultation agreed with ESMA's approach of not making prescriptive and detailed proposals, but rather proposing very general principles so as to avoid stifling development and innovation or creating regulatory inconsistencies.

2. Many respondents expressed their preference for clear definitions of expression such as "sustainability risks" and "sustainability factors". The SMSG also commented on this matter, stating that the lack of agreed definitions and labels at an EU level is a substantial shortcoming and seriously hampers the implementation of a harmonised approach to sustainable finance. According to the SMSG, 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.

ESMA's response refers to the new Regulation on disclosures relating to sustainable investments and sustainability risks, which contains several key definitions, and highlights that, in its final document, it urges the EC to take those definitions into account with regard to all the directives analysed.

3. Another common point in the responses received is the need to have a common taxonomy and standardised practices prior to any regulatory reform. The SMSG also highlighted the negative impacts of a lack of a common taxonomy. These include, for example, (i) the development of products claiming incorrectly to be "sustainable", thus misleading investors; (ii) a lack of clarity and/or a multiplicity of approaches that may create misunderstandings; (iii) a plethora of labels in different European jurisdictions and (iv) the impossibility of developing pan-European products and the consequent difficulties for exporting them to other markets.

ESMA considers that although this is an important point, it is not included in the mandate from the EC, but it will take it into account when updating its Guidelines on product governance.

4. The SMSG highlights the fact that sustainable finance is an evolving field and, therefore, constantly changing. It therefore suggests that in order to achieve supervisory convergence, a review clause in respect of regulation should be included.

5. A considerable number of respondents to the consultation indicated the importance that the technical advice be consistent with the different legal texts analysed and that the same terminology should be used in all of them.

ESMA has taken this point into account and, in fact, has liaised closely with EIOPA to ensure consistency between the standards and concepts of both sectors.

6. Respondents to the questionnaire have expressed their concern about the timing in the application of the requirements resulting from these legislative changes. Some have suggested that they should be given a period of 18 months, while others requested that the new obligation should not be enforceable until application of the new Disclosures Regulation.

ESMA advises the EC that the mandatory nature of the requirements relating to sustainability criteria and risks should be postponed until effective application of the aforementioned Regulation in order to give all those affected by the legislation sufficient time to adapt their internal processes and organisations.

7. Finally, it is important to note the warning of the SMSG that the principle of proportionality needs to be taken into account to prevent smaller firms incurring excessive costs as a result of rigorous application of the legislation.

ESMA agrees with the SMSG, but considers that this principle is already embedded in all the revised Directives and it is, therefore, not necessary to add a specific recital reaffirming the principle of proportionality.

Cost-benefit analysis

Both reports contain a cost-benefit analysis, which is basically qualitative as the quantitative data obtained were not sufficiently representative.
Final proposal to the EC

Finally, ESMA's technical advice proposes the following legislative changes to the EC:

A. *In the area of investment firms* (MiFID II)

1. Organisational requirements (Article 21(1) of the MiFID II Delegated Regulation 2017/565): inclusion of environmental, social and governance considerations in this article so that all investment firms should take them into account when complying with the requirements set out in this provision.

2. Risk management (Article 23 of the MiFID II Delegated Regulation 2017/565): inclusion of sustainability risks in this article so that investment firms should integrate them into their risk management systems and processes.

3. Risk management (new recital in MiFID II Delegated Regulation 2017/565): the intended aim is to clarify that investment firms' compliance function and internal audit function must manage sustainability risks in their respective duties.

4. Conflicts of interest (new recital 59 (bis) of the MiFID II Delegated Regulation 2017/565): the intended aim is for investment firms to have in place appropriate arrangements to ensure that the inclusion of environmental, social and governance considerations in the advisory process and portfolio management does not lead to mis-selling practices that harm investors' interests.

5. Product governance (Articles 9(9), 9(11), 9(14), 10(2) and 10(5) of Delegated Directive 2017/593): inclusion of environmental, social and governance preferences and characteristics in these articles such that when investment firms determine which are the target markets of the financial instruments to be distributed, they should take into account the aforementioned characteristics of such instruments, as well as the environmental, social and governance preferences of potential clients.

B. *In the area of investment funds and collective investment scheme management companies* (UCITS and AIFMD)

1. Organisational requirements (Articles 4, 5 and 9 of Commission Directive 2010/43/EU and Articles 22, 57 and 60 of Commission Delegated Regulation 231/2013): inclusion in these articles of sustainability risks so that management companies and self-managed funds take them into account when complying with organisational requirements, with the obligation to have adequate resources to ensure their effective integration in the organisation. In addition, ESMA proposes establishing requirements with regard to this new obligation for the senior management at management companies.

2. Operating conditions (new recital 17 (bis) and amendment of Article 23 of Commission Directive 2010/43/EU, new recital 48 (bis) and amendment of Article 18 of Commission Delegated Regulation 231/2013): inclusion of sustainability risks in the aforementioned provisions with the aim of management companies and self-managed funds integrating them in the management procedures for conflicts of interest and due diligence.

ESMA also proposes that the negative impact of investment decisions on sustainability factors should be taken into account and that management companies should also develop strategies to minimise it.

3. Risk management (Article 38 of Commission Directive 2010/43/EU and Article 40 of Commission Delegated Regulation 231/2013): inclusion of sustainability risks in these articles with the aim that the management companies integrate them into the evaluation that they perform on the exposure of the funds that they manage to certain risks.

Links of interest:

Final report on integrating sustainability risks and factors in the MIFID II

Final report on integrating sustainability risks and factors in the UCITS Directive and the AIFMD