Ref.: ESMA Public Consultation on integrating sustainability risks and factors in MiFID II

Submitted: 19 February 2019

Addressees: investors, consumer groups, trade associations, investment firms, credit institutions performing investment services, competent authorities and firms that are subject to Directive 2014/65/EU (MiFID II)

Link:https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-mifid-ii

BETTER FINANCE RESPONSE

Summary of the public consultation (PC): As part of the measures on sustainable finance, the EC requested EIOPA and ESMA to develop technical advice for integrating sustainability factors into the general provisions laying down organisational requirements and product governance rules for investment and insurance firms in MiFID II and IDD Level 2 legislation, as well as for the suitability assessment. This consultation paper analyses the possible amendments to the recitals or provisions of the MiFID II Delegated Regulation insofar as product manufacturers and distributors would consider sustainability factors within their business, including investment advice.

Structure:

- Organisational requirements – Questions 1-4;
- Product governance – Questions 5-9;
- Suitability – Questions 10-13;
- Cost-benefit analysis – Question 14.

Link to the file: https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-mifid-ii#registration-form_consultation

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This paper represents the response of BETTER FINANCE, The European Federation of Investors and Financial Services Users. BETTER FINANCE is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

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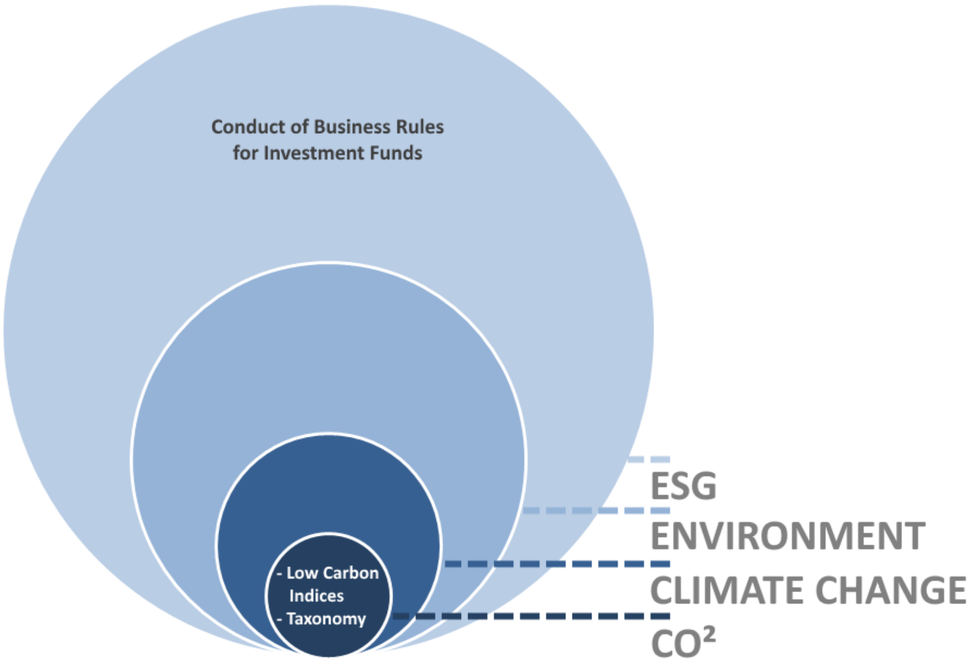
General comment

Due to the highly (and often non-financial) technical considerations underlining this consultation, some of the questions fall out of BETTER FINANCE's remit of competence and representation. However, BETTER FINANCE believes that a few targeted comments to key questions concerning the identified areas would provide valuable support for ESMA's task. Therefore, this response contains input only to the identified key questions of the Public Consultation of ESMA.

From the multitude of references ESMA makes in this new emerging field, BETTER FINANCE believes one should avoid any confusion between the fields of climate change, environmental issues, responsible investment, sustainable finance and ESG. For this purpose, BETTER FINANCE wishes to put forward a simple infographic to ensure one know which topic and which scope its policy mentions regard:

SCOPE OF THE EU SUSTAINABLE FINANCE ACTION PLAN | ENVIRONMENTAL - SOCIAL - GOVERNANCE (ESG)



This graphic shows that the scope of this ESMA consultation is extremely different and broader than climate change.

BETTER FINANCE has welcomed[1] the European Commission's Sustainable Finance Action Plan and the measures therein to increase transparency and oblige the finance industry to apply ESG criteria to their own activities, favouring sustainable long-term value creation.

[1] See BETTER FINANCE Press Release, 'BETTER FINANCE Welcomes the Sustainable Finance Action Plan but Warns the Commission Against its Plans Regarding Taxonomy, Benchmarking and Eco-label', 20th July 2018 https://betterfinance.eu/publication/better-finance-welcomes-the-sustainable-finance-action-plan-but-warns-the-commission-against-its-plans-regarding-taxonomy-benchmarking-and-an-eco-label-2/.

It is important to stress that the building blocks of a sustainable and long-term investment environment are information transparency and disclosure, coupled with a proper taxonomy of sustainable finance products and exemplary compliance with investor protection rules.

EU households are the main source of long-term financing that can be better allocated to sustainable securities and assets. However, it proves paramount to ensure that investment advice properly takes into account savers' ESG preferences and that ESG-factored products are fully compliant and aligned with the best interests of retail investors. To the latter extent, BETTER FINANCE refers to its responses to the parallel public consultation from ESMA on integrating sustainability risks and factors into the internal management processes offund managers. Tt would seem that this consultation and the one on fund managers are not always consistent.

There are several issues BETTER FINANCE wishes to highlight.

A clear and common taxonomy first

First, in order to prescribe conduct of business rules and issue guidelines to financial services providers on how to integrate ESG into their activities, the EU needs a common and clear set of definitions and classifications for ESG. This would also prevent confusions and misconceptions, which is pivotal for a good kick-off of this initiative. With such a large and diverse scope, the ESG taxonomy cannot be left for self-regulation or "best practices", but must be established through directly applicable, binding provisions at Union law level. It is not up to individual providers or distributors to have to decide – for example – if nuclear power providers should be excluded, under weighted or over weighted in their portfolio in order to integrate climate change factors and risks. First most of them if not all are not competent to assess the overall impact of such an economic activity on climate change, second there is a high risk that they would contradict one another on this assessment, seriously damaging any chance to achieve the goals of the sustainability action plan of the EU.

Second, the European Commission (EC) must ensure through its measures that sustainable finance and the ESG movement is not turned into a marketing gimmick, whilst also safeguarding against "greenwashing". For these reasons, a clear and compulsory taxonomy must be first established, and it must address all three dimensions of ESG, not only the first. Otherwise, the is a risk of overweighting the "E" factor to the disadvantage to the "S" and "G", which are equally important. The mandate to ESMA did not envisage this, which will lead to confusion and divergent application of the law since asset managers are required to screen and consider factors that are nowhere defined in the law.

Exemplary compliance with investor protection rules

First, BETTER FINANCE is supportive of increased disclosure relating to sustainability and ESG-responsible governance. We wish to stress again the need to ensure exemplary compliance with EU consumer and investor protection rules, in particular information and disclosure ones.[2] In absence of trustworthy financial products and services, the sustainable finance initiative cannot take off and it will likely remain a marketing gimmick. In particular, BETTER FINANCE draws

[2] Press Release, 'Sustainable Finance Products Must Fully Comply with Consumer Protection Rules and Really Create "Long-Term and Sustainable Value"' 13 July 2017 - https://betterfinance.eu/publication/sustainable-finance-products-must-fully-comply-with-consumer-protection-rules-and-really-create-long-term-and-sustainable-value%C2%9D/.

attention to Article 24(1) of MiFID II on acting "*honestly, fairly and professionally in accordance with the best interests of its clients*", and to Article 24(3) requiring all information addressed to be "*fair, clear, and not misleading*". Evidence already published by BETTER FINANCE proves that disclosures on "green" investment products is too often unclear and misleading.

Second, the EU should ensure that investors are not mislead and that sustainability factors are considered at the core of the internal management processes. Therefore, the EU should include *sustainability risks and factors* into the provisions on general principles and information to clients, and assessment of suitability and appropriateness and reporting to clients.

Last, as an overarching comment, BETTER FINANCE is concerned with the high-level principle-based approach since it is not strong enough to ensure consistent application throughout the Capital Markets Union. Already there is disparity in the transposition and implementation of EU financial law by national competent authorities. Moreover, even a directly applicable principle-based approach would already allow a margin of appreciation for investment firms. If continued with the approach as such, it could easily lead to circumvention of these provisions and create an unlevel playing field.

Straightforward conduct of business rules

At times, it may seem like the advice of ESMA is devoid of practical effects since the "*high-level principle-based*" approach only provides a vague indication of a final result to be achieved by asset managers. Our preliminary view is that, for financial services providers, distributors, advisors, clients, it is unclear how should the sustainability risks and factors be practically integrated in their activities.

ESMA refers to "*integrating sustainability risks* ***and factors***" in the headline, but only proposes a definition to sustainability risks. Moreover, **both** consultation papers refer,[3] in fact, only to sustainability risks. ESMA should be very straightforward on what precisely it is asking asset managers to undertake.

However, if ESMA does indeed aim to only provide a final target to be achieved at the discretionary powers of investment firms, that of having integrated "*sustainability*" in their organisational, advisory, distribution, transparency, disclosure and product governance processes, then this approach is may not advisable as the methods and approaches will vary as much as financial services providers vary.

In fact, BETTER FINANCE's biggest concern is on the retail distribution channels (points of sale). Advice and suitability assessments provided by advisors with the proper training and knowledge are vital for ensuring that the investor's ESG preferences are appropriately taken into account and that the investor:
(a) properly understands the risks, including the sustainability risks and
(b) takes an informed decision.

ESG is very centered on the non-financial considerations, or the negative externalities of economic activities and transactions, which may find themselves – at times – in contradiction with the aim of achieving returns as high as possible with risk as low as possible. The issue is

[3] This consultation paper and that on integrating sustainability risks and factors into MiFID II Delegated Regulation (ESMA35-43-1210).

that, in the end, we are not completely sure we understand how an asset manager would be supposed to "integrate" sustainability risks and still fulfill their fiduciary duties to create and protect value, since sustainability.

Organisational requirements

Summary: *ESMA proposed three targeted amendments, following a high-level principle-based approach, in the MiFID II Level 2 legislation to explicitly include ESG considerations into the general organisational requirements (Article 21), risk management (Article 23), and conflicts of interest (new recital 59 bis) procedures and policies for the investment decision and advisory processes.*

Question 1: 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.

ESMA should coordinate the proposals with the parallel public consultation on integrating sustainability risks and factors into the UCITS Directive and AIFMD Level 2 legislation. Thereof, ESMA expressly provided that the staff responsible for all aspects of internal management related to sustainability risks and factors integration should possess the relevant skills, knowledge and expertise or should be provided with training in this light.

The purpose of these measures is to integrate sustainability risks and factors into the management and governance processes of investment firms and advisors. Therefore, while respecting the principle-based approach, ESMA should have identified and amended accordingly the provisions relating to executive remuneration, internal audit and compliance functions so as to accommodate sustainability considerations in these fields as well.

Without a general requirement for product manufacturers to ensure that all key aspects and functions related to internal management take into consideration sustainability risks and factors, the objectives of the measures cannot be achieved.

Question 2: 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 reason for your answer.

BETTER FINANCE believes that the proposed modification to Article 23 meets its purpose of integrating sustainability risks and factors into the risk management process but disagrees with the justification in paragraphs 9 and 11 concerning the taxonomy and the compliance/internal audit functions.

The taxonomy considerations are expressed under the general comment above, while the compliance and internal audit functions' criticism is expressed under the answer for Question 1 above.

Question 3: Do you agree with the suggested approach and the new recital on 'conflicts of interest'? Please state the reasons for your answer.

BETTER FINANCE disagrees with the approach of ESMA of merely modifying a recital on the conflicts of interest policy. The risk of conflicts of interests is higher for "green" products. It is clear for ESMA and all stakeholders that recitals preceding a piece of EU legislation do not have a binding force, and can maximum provide an interpretation of the relevant articles.

Modifying a non-binding, explanatory text in an already non-directly applicable Directive surely cannot "*ensure that firms have in place appropriate arrangements*"[4] to prevent conflicts of interests, mis-selling or misrepresentations. What is more, these amendments would also be watered down by the proportionality principle justified by ESMA.[5] If ESMA wishes to ensure a level-playing field and actual, proper integration of sustainability risks and factors into the financial industry, directly applicable measures need to be taken, especially since the issue of conflicts of interests is, and has been, a key topic of investor protection and it cannot be treated residually as such.

What would be specific examples of conflicts of interest that might arise in relation to sustainability considerations?

For specific examples, see our reply to question 5 below. Too often, the MIFID-required prominent warnings on weaknesses and risks are missing. Without strict rules and their strict and consistent enforcement, conflicts of interest will be even more acute in "ESG" labeled or marketed products.

Question 4: 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.

N/A.

Product governance

Summary: *The EC asks ESMA to ensure that the provisions laying down the product manufacturers' obligations towards clients during the build-up, distribution and management of investment products take into account sustainability factors. ESMA identified the target market assessment as the key provision for "the common, uniform and consistent application" of the product governance rules laid down in Articles 16 and 24 of MiFID II, implemented by Articles 9 and 10 of MiFID II Level 2 legislation. Thus, ESMA proposed making a simple reference to "ESG considerations" in Articles 9 and 10 of Level 2 legislation and amending ESMA Guidelines on product governance.*

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?

N.A.

Do you see any issues when relying on current market standards or "labels"? Please describe.

BETTER FINANCE does not know what ESMA means by "market standards" regarding the integration of ESG factors, but knows quite well about ESG labels, and warns about incentivizing the use of different existing ecolabels. BETTER FINANCE has published research findings last year that show that a current Government label led to publicly reward (and incentivize sales of course) an SRI fund that mimicked its general market benchmark before fees (generating two issues: first suspicion of being a falsely active funds, and second not differentiating its return and risk profile from the general equity market by using ESG selection criteria), and severely underperformed it after fees over the last ten years. Those three issues in addition could not be detected by individual fund investors due to the lack of clarity of disclosures (OECD surveys,

[4] Consultation Paper, page 10, paragraph 13.
[5] Ibid, paragraph 15.

among others, show that a large majority of individual investors do not know how to compute compound returns), and to the lack of the MIFID required warnings.

For one, there is no warning that the fund consistently failed to meet its own investment objective over ten years and destroyed the real values of its clients' money over the same period.

Therefore, BETTER FINANCE recommends ESMA to instead draft guidelines on what would be the minimum criteria and elements of the future EU ecolabel to be referred to in assessing the target market for potential clients. As such, in absence of regulatory provisions at Level 1 or 2, ESMA could attempt to ensure a minimum harmonization across industry practices in the CMU.

Question 6: 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.

BETTER FINANCE disagrees with the justification and proposed plan of action of ESMA, based on several considerations indicated above. First, leaving flexibility both to investment firms, distributors and to national competent authorities is the key factor for diverging implementation of EU law, uneven playing fields among market participants and fragmentation of the CMU. The purpose of both MiFID II and the subsequent implementing or delegated acts is to ensure harmonization across the areas covered by those legal acts.

Second, in absence of a clear taxonomy on the ESG definition and coverage, a "simple reference" to ESG considerations leads to an indefinite number of interpretations and, obviously, products. It may create the situation where the ESG investment fund (for example) may have completely different characteristics and target markets across the CMU.

Third, in the context of incentivizing cross-border distribution of investment products, the regulatory arbitrage left open by ESMA may lead to situations where a product cannot be distributed in other Member States due to a different understanding of the label as such due to different national measures.

Last, in line with the proposals on the green products and Ecolabel, ESG considerations must be accounted for in the same manner across the CMU if there is any desire to reduce confusion among investors and increase confidence in an untrusted financial industry.

Question 7: 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.

BETTER FINANCE agrees as a matter of principle with the proposed modifications but stresses the need to distinguish between certain hypotheses that may arise due to non-ESG preferences. This answer is tied to the answer to Question 11 below on the target market assessment.

If an exclusionary approach would be adopted as part of the "ESG positive products" screening, where a specific client would not have ESG preferences but would indicate the wish to invest in a sector incompatible with ESG (see answer to Question 13 below), then it would necessarily mean that an "ESG positive product" would be incompatible with the non-ESG preferences of the client and a negative target market would need to be identified.

Therefore, BETTER FINANCE suggests that ESMA clarifies this particular possibility to financial advisors that non-ESG objectives and needs may automatically make an "ESG positive product" and its target market unsuitable for the respective client where the non-ESG preferences are incompatible with ESG factors (potentially part of an exclusionary list).

Question 8: Do you think extra guidance is needed on the elements listed in paragraph 16 above? If yes, please provide details.

N/A.

Question 9: 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.

BETTER FINANCE would have gladly welcomed this approach as it is the fundamental building block for the entire sustainable finance initiative. However, addressing this issue through ESMA Guidelines under a case study is not the mean to do achieve it and it should be at least addressed through a dedicated provision in Level 2 legislation.

Environmental, Social and Governance considerations are very broad fields and encompass many topics and sectors but are not intrinsically connected. Examples can be found where a financial asset may be “E” and “G” compliant, but inconsistent with the “S” dimension. ESG considerations should be viewed as a single factor, but detailed provisions should be laid down, in order not to reduce the efficiency thereof.

This requires a two-step approach: first, a singular identification of each dimension is needed; then, it should be analysed whether a product fulfils at least one criterion from each of the three dimensions. This approach could be complemented by an exclusionary screening, i.e. where a product fulfils criteria from at least one dimension but does not transgress any of the other two.

Any other approach would lead to inconsistencies between the purpose of sustainable finance and ESG considerations and their actual implementation.

Suitability

Summary: *The EC asked ESMA to develop amendments to its Guidelines on suitability assessment to complement its Delegated Regulation on ESG preferences on the distribution of investment products. ESMA seeks to amend the “best practice” in investment advice as taking into account non-financial objectives such as ESG preferences and what type of information should be collected.*

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”? Please describe.

BETTER FINANCE reiterates its answer to Question 5 concerning “market standards” and labels and suggests it would be best that ESMA develops guidelines instead of referring to local labels.

Question 11: 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?

BETTER FINANCE agrees with the justification and proposed approach by ESMA on this particular issue.

As pointed out in previous responses by BETTER FINANCE, the "target market" approach also misses the elimination of toxic products that cannot "target" any market at all. Again, we define as toxic investment products, one where the ex-ante probability of destroying the real value of the investment over the recommended holding period is high or very high.

Question 12: 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.

BETTER FINANCE reiterates its answer to Question 9 above.

Question 13: Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

BETTER FINANCE wishes to warn ESMA on the fact that investment that are not categorized as ESG-compliant might in fact be inherently contradictory with ESG preferences. This is not universally applicable. However, should a sustainable finance label be adopted where a two step screening based on the exclusionary list of activities (tobacco production, military equipment etc.), investment that are not categorized as ESG-compliant due to the exclusionary list should automatically be deemed unsuitable for clients who have expressed ESG preferences.

Therefore, ESMA should clarify this point in its Guidelines and prepare for all possibilities as this argument remains valid even in absence of a sustainable finance label or ecolabel for financial products.

In addition, concerning paragraph 17 (page 24), BETTER FINANCE highlights that it is good in principle to ensure that firms put in place appropriate arrangements to prevent mis-selling practices or acting against client interests, but this is rather vague and it should be complemented by further Level 2 requirements.

Cost-benefit analysis

Question 14: 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 organization and the nature, scale and complexity of the activities of your institution, where relevant.

N/A.