Ref.: ESMA Public Consultation on integrating sustainability risks and factors in the UCITS Directive and AIFMD (ESMA34-45-569)

Submitted: 19 February 2019

Link to the file: https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-ucits.

BETTER FINANCE RESPONSE

Summary of the public consultation (PC)*:* The European Commission (EC) engaged in a project of overhauling the EU financial framework in line with the actions identified in the "Action Plan: Financing a Sustainable Growth". The project consists of a package of measures (amendments to existing legislative and non-legislative acts; adoption of delegated acts) in order to increase transparency and disclosure of asset managers in the field of sustainable investments. Among the measures, the EC aims to improve disclosure on how asset managers integrate ESG factors in their risk management processes.[1]

The EC formally asked ESMA to provide technical advice on supplementing, amending, or adopting new delegated acts for the proposals on sustainable finance. This public consultation focuses on the investment management part (UCITS and AIFs) and aims to gather feedback on "*integrating sustainability risks and factors in the internal processes and procedures of UCITS management companies and alternative investment fund managers (AIFMs)*".[2]

Structure:

- Definition of "*sustainability risks*" – Question 1;
- Organisational requirements – Questions 2-4;
- Operating conditions – Questions 5-8;
- Risk management – Questions 9-12;
- Cost-benefit analysis – Question 13.

[1] ESMA Consultation Paper, page 4.
[2] ESMA Consultation Paper, page 5.

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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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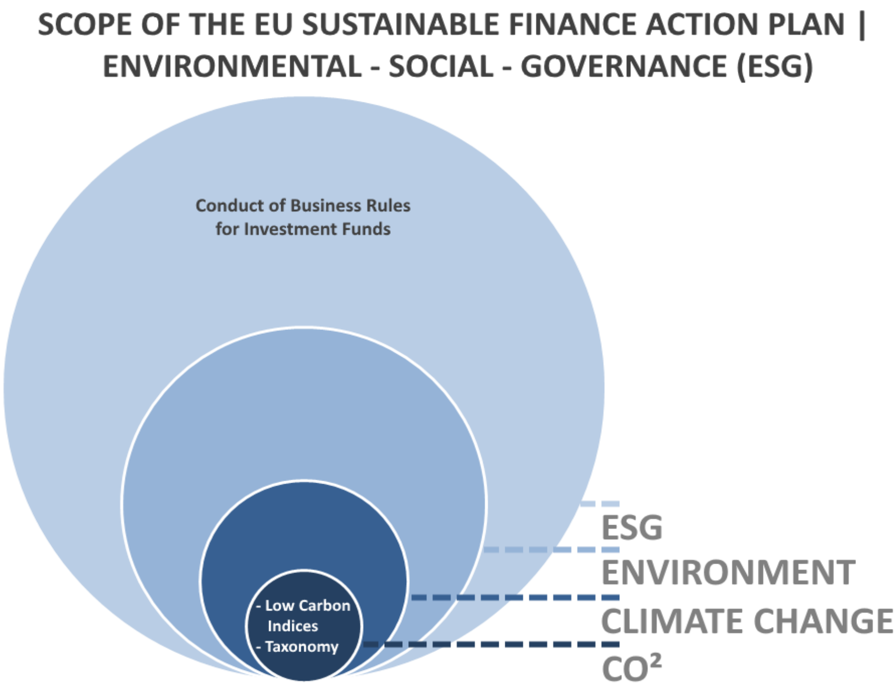
General comment

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 four identified areas of conduct of business 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:



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

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. It would seem that this consultation and the one on fund managers are not always consistent.

BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

BETTER FINANCE welcomes the proposed measures by the European Commission (EC) to integrate sustainability risks and factors in the investment decision-making processes of the EU fund management industry but warns ESMA and the EC on several issues.

Ensure long-term and sustainable value creation

The financial industry can play a key role for mitigating challenges deriving from Environmental, Social and Governance (ESG) considerations. Such considerations can also contribute to shifting from short- to long-termism in investments, which is necessary for improving long-term "decent" returns on capital and preserving market integrity. The purpose of these measures should be to:

- increase transparency and disclosure of sustainable finance considerations; and, where applicable,
- ensure that the proper mechanisms are put in place, so sustainability risks and factors are taken into account.

Exemplary compliance with investor protection rules

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.[3] In absence of trustworthy financial products and services, the sustainable finance initiative cannot take off and it will remain a marketing gimmick. In particular, BETTER FINANCE draws 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*".

A clear and common taxonomy first

In order to prescribe conduct of business rules and issue guidelines to asset managers on how to integrate ESG factors and risks into their activities, the EU needs a common, simple 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 fund managers 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

[3] 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/.

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.

BETTER FINANCE believes that it is irresponsible to require fund managers to integrate ESG factors without first agreeing on what they are.

Straightforward conduct of business rules

At times, it is unsure if ESMA rules will have practical effects since the "*high-level principle-based*" approach only provides a vague indication of a final result to be achieved by fund managers. Our preliminary view is that it is unclear HOW they 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,[4] 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 fund managers, that of having integrated "*sustainability*" in their organisational, advisory, distribution, transparency, disclosure and product governance processes, then the methods and approaches will be at risk to vary a lot.

ESG is about 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 long term value creation.

Definition of "sustainability risks"

Summary: *Since there is no definition in the UCITS and AIFM frameworks for "sustainability risk", ESMA proposes using a definition based on the concept of sustainable finance defined by the EC.[5] Therefore, sustainability risk would be understood as "the risk of fluctuation in the value of positions in the fund's portfolio due to ESG factors".*

Question 1: 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?

BETTER FINANCE is of the view that the definition given by ESMA to sustainability risk – "*the risk of fluctuation in the value of positions in the fund's portfolio due to ESG factors*" – is not correct due to two shortcomings, explained below. However, if ESMA is to move ahead with this definition, at least the time horizon of the recommended holding period must be included.

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

[5] The EC refers to sustainable finance as the process of integrating ESG factors in the investment decision-making processes of a fund – see Commission Staff Working Document, Impact Assessment (SWD(2018) 264 final- 24 May 2018 – page 11.

The "risk of fluctuation in value" is highly dependent upon the investment's time horizon, and even more so if it is due to ESG factors, as those factors are much more likely to generate investment risks over the medium- and long-term rather than over the short term.

Investment risk is also not limited to asset value volatility; BETTER FINANCE has several times alerted EU Authorities to misperceptions of the notion of "investment risk". For instance, a money market fund is typically not a risky investment over the short-term; however, over the long-term it is a highly risky investment as there is a close to 100% probability to incur losses in real terms (after deduction of fees and inflation adjustment);

Financial risk is referred to as:
(i) the **probability** and
(ii) **magnitude** of financial loss which, transposed to investment funds, means the likelihood of an asset's value to drop compared to the initial financial position over a certain time horizon.

For instance, a diversified portfolio of equities is often less volatile and less risky than a portfolio of bonds over the long term. Financial risk takes more forms, among which is also volatility risk, referring to *fluctuations in the value of a financial position*, which is necessarily correlated with the product's maturity (investment horizon). Otherwise, using short-term volatility measures for long-term investments does not make sense and is very misleading (see example of money market funds above). Therefore, ESMA's proposed definition implicitly refers to volatility risk. Nevertheless, if it would be anchored in volatility risk, it must encompass the maturity dimension of a product.

Second, sustainability should encompass ESG factors, but it must be clearly delimited how these create a risk for investment returns. The industry already identified several ESG-related risks, such as reputational or market risk, that derive from non-ESG compliant products. The wording therefore should be changed to "*caused by non-compliance with ESG factors*".

Therefore, BETTER FINANCE proposes that sustainability risk be defined as "*the probability and magnitude of incurring losses over the investment fund's recommended holding period caused by ESG factors*".

Organisational requirements

Summary: *Based on the high-level principle-based approach, ESMA proposed targeted amendments to key provisions of the UCITS and AIF Level 2 legislation on organisational requirements for the management undertakings, i.e. Articles 4, 5 and 9 of Commission Directive 2010/43/EU (UCITS) and Articles 22, 57 and 60 of Commission Delegated Regulation 231/2013 (AIFs).*

Question 2: 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.

BETTER FINANCE considers that a high-level principle-based approach would not eliminate the risk of divergent application of these provisions. Hence, BETTER FINANCE advises ESMA to consider supplementary amendments to the precited legislation.

A principle-based approach would indeed reduce compliance costs and the regulatory burden for financial market participants. However, too many reports of independent organizations and of the European Supervisory Authorities (ESAs) have noted the insufficient convergence in the implementation of EU legislation across Member States, especially since the rules on UCITS management are issued through a Directive.

The principle-based approach would be suited provided that all other implementing provisions of the precited legislation would be sufficiently granular so as to allow harmonized application across the EU. However, even at a principle-level, the approach does not touch all necessary aspects of the internal governance of fund management companies, such as conflicts of interests, responsible persons, transparency and disclosure.

Therefore, BETTER FINANCE sees as necessary to complement the amendments with several other modifications of key provisions, which could include:

- definitions – it is paramount that a common approach to *sustainability risk* and *ESG factors* is given in this context, reason for which we refer to our answer to Question 1 and to our Press Release on the Sustainable Finance Taxonomy: i.e. a common taxonomy (i.e. a common definition of "ESG factors" and of economic activities that are determined to be helpful or detrimental to the environment, and to social and governance standards) should come first, before integrating ESG risks and factors into asset management processes; or
- periodical reviews the suitability and effectiveness of policies, arrangements and procedures put in place in order to comply with Article 4 and Article 5(5);
- remuneration and executive pay, internal audit and compliance functions that would be obliged to ESG considerations as well.

On the latter point, BETTER FINANCE wishes to highlight that a mere "***it would also be expected*** *that both the Compliance function and Internal Audit incorporate in their control programs*" ESG considerations reflects a lack of ambition and falls short from what is necessary or from what the EC asked. In the first phase of restoring confidence in the financial sector, nothing can "be expected" from the asset management industry, but many should be **requested**.

The scope of the amendments is that management companies effectively consider ESG factors, not merely introduce the concept in the internal management processes. Therefore, all relevant areas must be targeted, even at a principle-based level.

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 (e.g. under Article 5 of the Commission Directive 2010/43/EU and Article 22 of the Commission Delegated Regulation (EU) 231/2013?

In line with the necessity to lay down more detailed provisions on integrating sustainability risks, BETTER FINANCE believes that there should be a specifically designated qualified person responsible with the integration of sustainability risks into the internal processes of the management company of both ESG-factored UCITS and AIF and other investments accordingly. However, the proportionality principle should be applied, with smaller entities exempted.

Operating conditions

Summary: *Based on the high-level principle-based approach, ESMA proposed targeted amendments to key provisions of the UCITS and AIF Level 2 legislation on operating conditions for the management undertakings, i.e. Article 23 of Commission Directive 2010/43/EU (UCITS) and Article 18 of Commission Delegated Regulation 231/2013 (AIFs).*

Question 5: 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.

BETTER FINANCE agrees with the identified articles in the Commission Directive 2010/43/EU and Commission Delegated Regulation (EU) 231/2013 concerning *due diligence* as regards the operating conditions of management companies of UCITS and AIFs.

However, BETTER FINANCE believes that these do not cover the entire scope of the EC request for technical advice, nor do they address all aspects of integrating sustainability risks into the conduct of business of management companies.

First, conflicts of interest is a topic of utmost importance for sustainable finance and ESG and it actually touches on the "**G**" dimension, reason for which ESG factors cannot be fully integrated if there isn't a clear policy on preventing or disclosing conflicts of interest related to ESG-excluded or non-compliant activities of UCITS or AIFs management firms or relevant persons therein.

Second, there are many types of conflicts of interest that may arise from integrating ESG factors into the investment management mechanisms. Due to the emerging nature of the field, many have not yet occurred in practice, reason for which preventive action must be taken at corporate governance level.

Question 6: 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?

Concerning the targeted amendments on due diligence proposed by ESMA, BETTER FINANCE believes that these provisions are sufficient to reach their target, i.e. thoroughly including sustainability and ESG factors into selection and ongoing monitoring of investments, including adequate knowledge of the former, and establishing written policies and procedures on due diligence.

We believe this is a crucial amendment proposed by ESMA as it indirectly, but materially, impacts the mandatory disclosure documents under the UCITS and PRIIPs legislative acts as pre-contractual disclosure to clients or potential clients.

If sustainability risks are taken into consideration in the selection, ongoing monitoring of investments, identification and assessment to risks that impact financial returns, these will need to be disclosed in the Prospectus of the product and, consequently, in the KIID (for UCITS and some AIFs) and PRIIPs KID (for AIFs other than those to which the UCITS regime applies).

Risk management

Summary: *Based on the high-level principle-based approach, ESMA proposed targeted amendments to key provisions of the UCITS and AIF Level 2 legislation on risk management requirements for the management undertakings, i.e. Article 38 of Commission Directive 2010/43/EU (UCITS) and Articles 40 of Commission Delegated Regulation 231/2013 (AIFs).*

Question 9: 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.

In line with the answer provided under Question 6 above, BETTER FINANCE believes that sustainability risk management is paramount for the proper assessment of the investment policy, risk profile and management of a UCITS or AIF.

Risk management procedures concerning sustainability risks directly affect the calculation and categorization of a risk profile for a UCITS or AIF, which is a key investor disclosure information both in the fund Prospectus and in the KIID or KID. Therefore, BETTER FINANCE agrees with the proposed amendments to Article 38 (for UCITS) and Article 40 (for AIFs).

However, BETTER FINANCE deems necessary to complement the proposals with:

- an amendment to Article 40 (Commission Directive 2010/43/EU), which lays down detailed provisions on measurement and management of risk, where a clear reference to sustainability risk needs to be made and it should be more precise the internal processes related to the latter; and
- an amendment to Article 38 (Commission Delegated Regulation (EU) 231/2013) which specifies the conditions and requirements for risk management systems to be included by AIF managers.

BETTER FINANCE would leave it up to ESMA to find the best solution to accommodate these interests to transparency and investor protection in the Level 2 legislation.