



European Securities and
Markets Authority

Final Report

ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD





European Securities and
Markets Authority

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1 Overview

Background

1. Sustainability has long been at the heart of the European project. Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the Commission has expressed in the 'Action Plan: Financing Sustainable Growth' its intention to clarify so-called fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities with the aim to:
 - reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
 - assess and manage relevant financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
 - foster transparency and long-termism in financial and economic activity.
2. On 24 May 2018, the Commission adopted a package of measures on sustainable finance. The package included proposals aimed at establishing a unified EU classification system of sustainable economic activities ('taxonomy'); improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their risk processes; and creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.
3. On 24 July 2018, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) received a formal request (mandate) from the European Commission to provide technical advice to supplement the initial package of proposals and to assist the Commission on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC (UCITS Directive), Directive 2009/138/EC (Solvency II Directive), Directive 2011/61/EU (AIFMD), Directive 2014/65/EU (MiFID II) and Directive 2016/97/EU (IDD) with regard to the integration of sustainability risks and sustainability factors.
4. The Commission requested ESMA and EIOPA to provide technical advice by no later than 30 April 2019.
5. During the preparation of this work, ESMA and EIOPA have closely liaised to ensure consistency across sectors.

Public consultation

6. On 19 December 2018, ESMA published a Consultation Paper (CP)¹ on the draft technical advice on integrating sustainability risks and factors in the UCITS Directive and AIFMD in order to explain its rationale and gather input from stakeholders. In addition, ESMA carried out an open public hearing on 4 February 2019 in order to gather additional feedback from stakeholders on the CP.
7. The consultation period closed on 19 February 2019.
8. ESMA received 60 responses, 6 of which are confidential. The answers received are available on ESMA's website unless respondents requested confidentiality. ESMA also received the advice of the Securities and Markets Stakeholder Group's (SMSG).²
9. The responses to the public consultation included some general comments that are summarised below:
 - Overall, a majority of respondents agreed with ESMA's principles-based approach to integrating sustainability risks and factors in the UCITS Directive and AIFMD since a more prescriptive regulatory approach for such a dynamic area might run the risk of stifling innovation or creating regulatory inconsistencies. The SMSG on this topic stated that it *"supports the view taken by ESMA in its presentation of the Approach to the Commission's request that the integration of sustainability risks and factors is better done through a high-level principles-based approach for the reasons explained in the CPs. The SMSG is keen to see this approach reflected in the specific wording that would be used to amend the existing regulations."*

For further details and for ESMA's views on this topic please see Chapters 2, 3 and 4 of this Final Report.

- Various respondents noted that relevant concepts and terms should be more clearly defined, in particular the notions of 'sustainability risks' and 'sustainability factors'. These respondents made different suggestions on how those terms could be defined and underlined the importance of having a shared understanding of relevant terms in order for market participants to comprehend how these proposed amendments would work in practice. Many respondents also argued that the notion of 'sustainability factors' should not be used in the technical advice at all, whereas others argued that the advice should rather use the notion of 'sustainable investments'. Some respondents asked ESMA to more clearly spell out that 'investment factors' may also encompass sustainability-related investment opportunities. Moreover, many respondents expressed the view that an explicit reference to the materiality of sustainability risk would be needed. In this context, the SMSG stated that *"the lack of agreed definitions and labels at the EU level is a substantial shortcoming and seriously hampers the implementation of a harmonized approach on sustainable finance. This should not prevent firms from making*

¹ [ESMA Consultation Paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD \(ESMA35-45-569\)](#).

² See Annex I of this Final Report.

progress in order to incorporate sustainability risks and factors, but this should be taken into account by regulators and supervisors.”

ESMA response: ESMA agrees on the importance of having clarity on the terminology used for the correct implementation of the proposed legislative amendments. ESMA is also of the view that the development of any binding definitions needs to consider all legislative initiatives developed on the topic of Sustainable Finance in order ensure a harmonised approach across sectors. For this reason, and also in light of the content of the mandate received, ESMA has refrained from suggesting new definitions in its draft technical advice, but is pleased to note that relevant definitions and clarifications will be included in the new rules on disclosure requirements on which the co-legislators have recently reached political agreement (hereinafter ‘Disclosure Regulation’).³ In this context, it is worth noting that the definition of ‘sustainability risks’ set out therein already refers to materiality.⁴ With a view to ensuring a consistent interpretation and application of the rules, ESMA invites the Commission to include cross-references in the Level 2 legislation covered in this technical advice to the relevant definitions set out in the Disclosure Regulation or include identical definitions under Article 1 of the Commission Delegated Regulation (EU) 231/2013 and Article 3 of the Commission Directive 2010/43/EU, in particular in relation to the notion of ‘sustainability risks’. In light of the final wording of the definition of ‘sustainability factors’ set out in the Disclosure Regulation⁵, ESMA has also adjusted the wording of the legislative proposals below. This is in particular because the final text of the Disclosure Regulation clarifies that the consideration of adverse impacts of investment decisions on sustainability factors will not be mandatory for all market participants.

- Many responses received from financial industry associations stressed the need of having a common and reliable taxonomy and standardised practices in place before any enhancements of existing financial market regulations come into effect. Some of these respondents stated that a clear and compulsory taxonomy should be established and that it should address all three dimensions of ESG in order to not create confusion and legal uncertainty. The SMSG also noted that it *“would indeed have much preferred the adoption of a clear and appropriate taxonomy and labels before investment firms, institutional investors and assets managers were requested to disclose how they integrate sustainability risks in the investment decision-making process or advisory process”*. The SMSG noted that a lack of common EU taxonomy has several potentially negative impacts:
 - *“It could lead to the development of products claiming incorrectly to be sustainable, leaving the investor with misleading guidance as to whether they incorporate environmental, social and corporate governance factors in their investment processes;*

³ [European Commission – Press release \(IP/19/1571\)](#)

⁴ Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on sustainability-related disclosures in the financial services sector, 2018/0179 (COD); Article 2(t).

⁵ Article 2(v): ‘sustainability factors’ mean environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.

- *A lack of clarity and/or multiplicity of approaches may also lead to misunderstandings, as well as frustrated expectations ('how' rather than 'whether' factors are incorporated);*
- *It can also be a source of litigation between clients and investment firms/funds;*
- *The conjunction of the European pro-active approach on sustainable products and of multiple labels and uneven stages of development could undermine risk-assessment and comparability for investors, and create a risk of crowding or bubble effects within certain asset-classes;*
- *Beyond the product offerings, a plethora of labels and approaches as well as an uneven degree of maturity across Europe in respect of the social and governance factors may also have an impact on available skills and resources, training, and controls;*
- *As many labels are national and do not necessarily benefit from a framework of accepted common criteria, it prevents to a certain extent the development of pan-European products and the export of EU products into non EU jurisdictions.”*

ESMA response: ESMA acknowledges the issue raised above and, although these issues go beyond the scope of the technical advice that ESMA is preparing in response to the Commission’s mandate, has included them in its Final Report in order to convey them to the Commission and for them to be considered within the broader initiative on Sustainable Finance. ESMA however, within the remit of its powers, will further reflect on these points when updating the guidelines on product governance during the course of 2019.

- The MSG highlighted that Sustainable Finance is an evolving field and noted “(i) *the need for supervisory convergence and (ii) the inclusion of a review clause in respect of regulation on sustainable finance*”.

ESMA response: ESMA agrees on the need for supervisory convergence and notes that this advice does not preclude further supervisory convergence work in this area (e.g. through Q&As and/or guidelines). ESMA also agrees on the merits of a ‘review clause’ in relation to the amendments to the UCITS Directive, AIFMD and MiFID II on the topic of Sustainable Finance and suggests that the Commission takes it into account when amending the legislative texts.

- A number of respondents underlined the need for consistency in the content of the advice and in the use of similar terms and concepts between the UCITS and AIFMD proposed amendments and the changes proposed with regard to the MiFID II, IDD and Solvency II frameworks.

ESMA response: ESMA agrees and confirms that during the preparation of the CP and the final technical advice, ESMA and EIOPA have closely liaised to ensure

consistency across sectors. In this respect, the SMSG stated that it “*supports the efforts of ESMA and EIOPA to ensure consistency across sectors in respect of the integration of sustainability into the regulatory framework. The SMSG urges ESMA to continue such efforts after the consultation phase*”. ESMA also confirms that it has intentionally used a terminology that is aligned to the one included in the Commission’s legislative proposals on Sustainable Finance.⁶ Considering however that the various legislative proposals are not final yet, ESMA encourages the Commission to perform a review of the terminology when adopting the final legislative acts in order to ensure consistency amongst the various measures.

- The issue of timing in the application of the new requirements is also recurrent among respondents from the financial industry. Some of these respondents suggested a minimum of 18 months for the implementation of the new Level 2 measures. Moreover, some respondents pointed to the need to align the implementation date of the proposed Level 2 measures set out herein with the application of the Disclosure Regulation so as to ensure consistency in the application, avoid confusion for investors and allow for lower implementation costs.

ESMA response: ESMA agrees that firms should be given sufficient time to implement the new requirements. As highlighted multiple times in this Final Report, the principles-based approach suggested by ESMA in its technical advice should allow UCITS management companies, self-managed UCITS investment companies, internally managed AIFs and external AIFMs (hereinafter: ‘authorised entities’) to adapt their organisations more efficiently, avoiding duplications and reducing costs related to the review of processes and systems. Moreover, ESMA invites the Commission to align the application date of the legislative amendments proposed herein with the application date of the relevant provisions in the Disclosure Regulation⁷.

- Finally, the SMSG noted that “*Smaller firms are very likely to struggle from a cost perspective with the impact of the new rules (access to resources, training, documentation, disclosures, controls and testing). Regulators and supervisors should be particularly cautious that smaller independent firms are not driven out. As proportionality is a cornerstone of the Commission’s better regulation policy, the SMSG would recommend that ESMA reaffirms the proportionality principle and where possible clarifies in a recital for instance how proportionality could be applied depending on the size, nature, scale and complexity of their activities*”.

ESMA response: ESMA agrees and notes that in its CP it had already emphasised that the proposed changes set out in the draft technical advice should all be applied

⁶ In the area of MiFID II, see for examples the definitions included in the ‘Commission Delegated Regulation amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) *considerations* and *preferences* into the investment advice and portfolio management’ or in the ‘proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU)2016/2341’.

⁷ REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 - COM(2018)0354 – C8-0208/2018 – 2018/0179(COD).



by authorised entities with the proportionality principle in mind, taking into account the size, nature, scale and complexity of their activities. The principle of proportionality is already explicitly reflected in the wording of some of the provisions where ESMA proposes legislative amendments.⁸ Moreover, there are a number of other relevant organisational requirements and risk management provisions and/or recitals in the UCITS and AIFMD Level 1 and 2 frameworks that refer to the principle of proportionality or have a wording that explicitly reflects this principle. Hence, ESMA is of the view that this principle is already clearly ingrained in the relevant legislation and therefore does not need to be re-affirmed in a new recital.

Cost-benefit analysis

10. A cost-benefit analysis of the draft technical advice is included in Annex II of this Final Report.

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11. This Final Report covers the topics on which the Commission has requested ESMA to provide technical advice, namely organisational requirements, operating conditions and risk management provisions set out in the UCITS and AIFMD Level 2 frameworks.

Next steps

12. ESMA will cooperate closely with the European Commission in view of the transformation of the technical advice into formal delegated acts.

2 Organisational requirements

Background/Mandate

Extract from the Commission's request for advice (mandate)

“Organisational requirements in delegated acts adopted under Articles 12(3) and 14(2) of the UCITS Directive (i.e. Commission Directive 2010/43/EU), [...] Articles 12(3) and 18(2) of AIFMD (i.e. Commission Delegated Regulation (EU) 231/2013, [...]) do not currently explicitly require the integration of sustainability risks. Where necessary for the achievement of consistency across sectors, EIOPA and ESMA are invited to also consider Article 135(1)(a) of the Solvency II Directive for potential new level 2 measures.

EIOPA and ESMA are invited to provide technical advices on corporate governance mechanisms within the organisation of the financial market participants and investment and insurance advisors, including, where relevant, but not limited to:

⁸ Articles 4(1) and 5(4) of the Commission Directive 2010/43/EU as well as Article 22(2) and 57(1) of the Commission Delegated Regulation (EU) 231/2013

- *tasks and the role of the risk-management function or procedures for risk assessment, the compliance function, the internal control function or system, the internal audit function and/or the actuarial function in the system of governance and tasks or responsibilities of bodies that undertake the management and supervisory functions in the corporate governance in relation to sustainability risk limits and overseeing their implementation;*
- *steps of procedures and processes to ensure the effectiveness and adequacy of sustainability risk integration;*
- *skill, expertise and knowledge required for the assessment of sustainability risks;*
- *regular reviews of the mechanisms put in place to integrate sustainability risks and regular internal reporting;*
- *adequate support to (e.g. analysis, research and legal advice), and resources across, all relevant functions and where several functions are involved in the integration of sustainability risks, the requirements on cooperation with each other; and.*
- *measures and policies specifically considering types of conflict of interest that might arise in relation to sustainability considerations and the steps to identify, prevent, manage and disclose them.*

Adapting processes, systems and internal controls to reflect sustainability risks is relevant in order to build the technical capacity and knowledge to analyse sustainability risks and ensure that the investment and advisory process is properly implemented and adhered to over time.”

Analysis following the public consultation

13. The majority of respondents agreed with ESMA's view that the integration of sustainability risks within the UCITS Directive and the AIFMD should follow a principles-based approach similar to that already followed for other relevant risks. These respondents pointed to the fact that there are several ongoing legislative procedures relating to Sustainable Finance and noted that prescriptive requirements in relation to sustainability risks at this stage may result in potential regulatory inconsistencies and legal uncertainty.
14. A few respondents disagreed with the principles-based approach applied by ESMA for the proposed amendments relating to organisational requirements. These respondents argued that the proposed provisions would be too vague and that such an approach would not guarantee a level playing field since market participants and NCAs would not necessarily interpret and apply those provisions in a consistent manner. Hence, these respondents argued for more granular provisions.
15. Conversely, some respondents argued that ESMA's proposed amendments could be misunderstood to mean that sustainability risks and factors should be assigned more importance in the organisation than other risks and factors. Some of these respondents expressed the view that no changes are needed to the organisational requirements.

16. **ESMA response:** ESMA is of the view that the proposed approach, as supported by the majority of respondents, is balanced and consistent with the Commission’s mandate without introducing overly prescriptive requirements at this stage.
17. The large majority of respondents saw no merit in introducing additional provisions requiring or elaborating on the designation of a qualified person responsible for the integration of sustainability risks and factors. These respondents argued that market participants should have the freedom to designate a specific person within their organisation as appropriate and that the organisational setup for the management of sustainability risks should not be different compared to other types of risks.
18. On the other hand, several respondents saw merit in designating a person responsible for the integration of sustainability risks and factors within the organisation, in particular as sustainability-related matters could be very different compared to financial risks and would therefore require a different set of expertise.
19. In this context, the SMSG noted that:
- “- each organization is different and should be able to carry out their own meaningful set up depending on the size, nature, scale and complexity of their activities,*
- this requirement can also be challenged from a proportionality standpoint,*
- the integration of sustainability risks and factors should be part of the clear definition of roles and responsibilities within a firm.*
- Nevertheless, the SMSG agrees that in order notably to ensure the awareness of the senior management and leadership on this sensitive topic, a person or function responsible for the integration of sustainability risks and factors should be identified. If such a requirement is introduced, ESMA should made clear that this requirement should be applied proportionally: this person should not be required to have an “established” expertise and should not dedicate 100% of his or her time to this task. The term “qualified” should therefore be deleted.”*
20. **ESMA response:** ESMA acknowledges that the explicit designation of a qualified person for the integration of sustainability risks and the consideration of adverse impacts of investment decisions on sustainability factors (where relevant) is not necessary to reach the desired objective of the European Commission. While in some cases there could be merit in designating a specific person within the organisation for sustainability matters, for example, by appointing a Chief Sustainability Officer, introducing such legal requirement for all market participants appears disproportionate at this stage. ESMA’s proposed amendments, notably those relating to Articles 5(5) and 9(2) of the Commission Directive 2010/43/EU as well as Articles 22(3) and 60(2) of the Commission Delegated Regulation (EU) 231/2013, should be sufficient to ensure that a) Senior Management is (collectively) responsible for the integration of sustainability risks and b) authorised entities (collectively) have the skills, knowledge and expertise to manage sustainability risks without the need to

necessarily designate a specific person as responsible or entrust a single person with all relevant tasks.

21. The majority of respondents did not propose any other amendments to the provision on organisational requirements in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III of the CP. These respondents were of the view that any additional requirements would not be in line with the principles-based approach suggested by ESMA and would signal a precedence of sustainability risks over other types of risks.

Technical advice

COMMISSION DIRECTIVE 2010/43/EU

Article 4 of the Commission Directive 2010/43/EU on “General Requirements on Procedures and Organisation” to be amended⁹ as follows:

Article 4

General requirements on procedures and organisation

1. 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

⁹ All proposed amendments are included as underlined text.

shall ensure that management companies take into account sustainability risks when complying with the requirements laid down in the first subparagraph.

2. [...]

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

Article 5

Resources

1. Member States shall require management companies to employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.

2. Member States shall ensure that management companies retain the necessary resources and expertise so as to effectively monitor the activities carried out by third parties on the basis of an arrangement with the management company, especially with regard to the management of the risk associated with those arrangements.

3. Member States shall require management companies to ensure that the performance of multiple functions by relevant persons does not and is not likely to prevent those relevant persons from discharging any particular function soundly, honestly, and professionally.

4. Member States shall ensure that for the purposes laid down in paragraphs 1, 2 and 3, 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.

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.

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

Article 9

Control by senior management and supervisory function

1. Member States shall require management companies, when allocating functions internally, to ensure that senior management and, where appropriate, the supervisory function, are responsible for the management company’s compliance with its obligations under Directive 2009/65/EC.

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

(a) is responsible for the implementation of the general investment policy for each managed UCITS, as defined, where relevant, in the prospectus, the fund rules or the instruments of incorporation of the investment company;

(b) oversees the approval of investment strategies for each managed UCITS;

(c) is responsible for ensuring that the management company has a permanent and effective compliance function, as referred to in Article 10, even if this function is performed by a third party;

(d) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed UCITS are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;

(e) approves and reviews on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed UCITS, so as to ensure that such decisions are consistent with the approved investment strategies;

(f) approves and reviews on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy, as referred to in Article 38, including the risk limit system for each managed UCITS.

(g) is responsible for the integration of sustainability risks.

3. [...]

COMMISSION DELEGATED REGULATION (EU) 231/2013

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

Article 22

Resources

1. AIFMs shall employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them.

2. For the purposes of paragraph 1, 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.

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

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

Article 57

General requirements

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 when complying with the requirements laid down in the first subparagraph.

2 [...]

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:

Article 60

Control by the governing body, senior management and supervisory function

1. When allocating functions internally, AIFMs shall ensure that the governing body, the senior management and, where it exists, the supervisory function are responsible for the AIFM's compliance with its obligations under Directive 2011/61/EU.

2. An AIFM shall ensure that its senior management:

(a) is responsible for the implementation of the general investment policy for each managed AIF, as defined, where relevant, in the fund rules, the instruments of incorporation, the prospectus or the offering documents;

(b) oversees the approval of the investment strategies for each managed AIF;

(c) is responsible for ensuring that valuation policies and procedures in accordance with Article 19 of Directive 2011/61/EU are established and implemented;

(d) is responsible for ensuring that the AIFM has a permanent and effective compliance function, even if this function is performed by a third party;

(e) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed AIF are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;

(f) approves and reviews on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed AIF, so as to ensure that such decisions are consistent with the approved investment strategies;

(g) approves and reviews on a periodic basis the risk management policy and the arrangements, processes and techniques for implementing that policy, including the risk limit system for each AIF it manages;

(h) is responsible for establishing and applying a remuneration policy in line with Annex II to Directive 2011/61/EU.

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

3. [...]

3 Operating conditions

Background/Mandate

Extract from the Commission's request for advice (mandate)

“Operating conditions in delegated acts adopted under Articles 12(3) and 14(2) of the UCITS Directive (i.e. Commission Directive 2010/43/EU), [...] 12(3), 14(4) and 18(2) of AIFMD (i.e. Commission Delegated Regulation (EU) 231/2013) do not establish the details of the integration of sustainability risks within the conduct of business or prudent person rules and due diligence requirements.

Financial market participants therefore should (i) define an investment strategy, (ii) where relevant, identify a proper asset allocation which clarifies how clients' money is allocated in accordance with the investment strategy, (iii) undertake proper due diligence in the selection and monitoring of investments, and (iv) ensure that the portfolios remain in line with the investment strategy and, where relevant, the asset allocation, while integrating sustainability risks.

The technical advices on the amendments of the respective delegated acts should be consistent with each other, while recognizing, where relevant, the difference in terminology used by ... the UCITS Directive and AIFMD. The technical advices should map the provisions of delegated acts that should be amended.”

Analysis following the public consultation

22. The majority of respondents were generally supportive of the proposed amendments to provisions relating to operating conditions. They noted that the regulatory approach proposed by ESMA is in line with the one followed for other relevant risks under both the UCITS and AIFMD frameworks.
23. However, many of those respondents highlighted that sustainability risks are not relevant in the same way for each investment or portfolio. Therefore, these respondents invited ESMA to make it more explicit that the proposed requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio. In this regard, some respondents stated that the proposed amendments to Article 23(5) of Commission Directive 2010/43/EU and to Article 18(5) of Commission Delegated Regulation 231/2013 might not be flexible enough to accommodate certain investment strategies such as index-based strategies where managers do not have any or only limited discretion in their portfolio management activities. Therefore, some respondents outlined the importance of ESMA clarifying that in those scenarios investment stewardship becomes an essential tool for fund managers to engage with investee companies on sustainability-related risks. Moreover, many respondents suggested complementing the aforementioned Articles with a wording such as “where appropriate” or “where relevant”.
24. **ESMA response:** ESMA agrees that the due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio and this

understanding is already reflected in existing UCITS and AIFMD frameworks as well as the relevant definition and clarifications provided in the Sustainable Finance Disclosure Regulation. Hence, ESMA is of the view that no further legislative clarifications are required in this regard.

25. Some respondents encouraged ESMA to provide more precise guidance on how to apply the due diligence requirements in practice and some referred to certain cases or situations where the application of the rules might not be so straightforward.
26. **ESMA response:** ESMA is of the view that, as described further above, more prescriptive legislative provisions at this early stage could raise the risks of regulatory inconsistencies and potentially stifle further innovation in this area. ESMA confirms that, considering the importance of the topic of Sustainable Finance as well as the rapid evolution of market practices and the legislative framework, it will monitor the phenomenon closely and that this advice does not preclude further supervisory convergence work in this area (e.g. through Q&As and/or guidelines).
27. Some respondents raised concerns since Article 23 of the Commission Directive 2010/43/EU and the Article 18 of the Commission Delegated Regulation (EU) 231/2013 require the use of “reliable and up-to-date information” in the due diligence process. Many respondents pointed to various challenges with respect to the availability and quality of relevant data. Some of these respondents noted that amendments to operating conditions must allow for more flexibility or additional wording that reflects these operational challenges.
28. Some respondents cautioned that authorised entities should not overly rely on data provided by unregulated service providers. While some of these respondents argued that authorised entities should have, or should be more explicitly required to have, internal processes to assess the quality of data and/or carry out due diligence with regard to the service providers, others argued that relevant service providers should be more specifically regulated.
29. **ESMA response:** ESMA acknowledges the operational challenges involved with getting reliable data on sustainability risks and factors. At the same time, ESMA points to the fact that the principle of proportionality is already clearly ingrained in the existing due diligence requirements as well as the additional wording proposed by ESMA. With respect to the comments by some respondents to provide additional guidance or more granular provisions on the due diligence process, ESMA considers that this would not be in line with the proposed principles-based approach. With regard to the comments that data service providers should be more specifically regulated to ensure sufficient data quality, ESMA notes that advice on the regulation of those entities is not covered by the mandate that ESMA received from the European Commission.
30. Most respondents did not see merit in ESMA providing at this stage further legislative clarifications on the identification and monitoring of sustainability risks, factors and indicators that are material for the financial return of investments.

31. Diverging comments were raised on ESMA's proposal to add recitals relating to conflicts of interest. A significant number of respondents noted that they could not see potential conflicts of interests that are particularly linked to sustainability risks. Therefore, they were of the view that singling out sustainability risks is unnecessary. Given that the existing rules on conflicts of interest laid down in the relevant legislations adequately cover every situation of conflicts of interest that may arise, there would be no merit in adding recitals.
32. Conversely, a number of respondents either supported the proposed recital, or suggested stronger measures, such as the inclusion of a specific article in the Level 2 text on conflicts of interest. These respondents argued that it is important to draw attention to potential conflicts of interests in this area, and that these conflicts should be managed effectively.
33. An investor protection association noted in this context that there are many types of conflicts of interest that may arise and that due to the emerging nature of the field, many have not yet occurred in practice, reason for which preventive action must be taken. Among the respondents who agreed with the proposed inclusion of recitals, several noted that they would welcome further clarification from ESMA, such as examples of possible types of conflicts of interests or scenarios where these could arise in relation to (the integration of) sustainability risks and factors.
34. **ESMA response:** ESMA is of the view that it is important to make clear references in the UCITS and AIFMD frameworks to the need to identify and manage conflicts of interest whose existence may damage the investors of a UCITS or AIF. The use of a recital over an article appears as a balanced approach in order to avoid giving excessive prominence to conflicts arising in relation to Sustainable Finance over other sources of conflicts of interest. This approach would provide the benefit of raising the attention of authorised entities and NCAs to this topic with a view to ensuring that authorised entities identify all relevant sources of conflicts of interest and make clear references in their conflict of interests policy on how relevant those are and how they are identified and managed. As supported by many respondents, ESMA has added some examples in the wording of the recitals.
35. Many respondents argued that no further amendments 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 of the CP are needed. These respondents argued that more detailed requirements would not be in line with the principles-based approach adopted by ESMA.
36. A few respondents invited ESMA to specify whether the investment analyses with respect to sustainability risks and factors should be performed at the level of each investment position or on an aggregated basis at the level of the overall portfolio. In this context, some argued that it should be acceptable to take higher sustainability risks on investments representing only a small proportion of the overall portfolio as compared to positions with a higher portfolio share, whereas others outlined the importance of assessing risks at the level of the individual investment positions.

37. A number of respondents suggested to more clearly link the integration of sustainability risks and factors to the fiduciary duties of asset managers. Some of these respondents pointed to the fact that the European Commission's Action Plan has the intention to clarify the fiduciary duties in the field of sustainability risks and sustainable investment opportunities and that ESMA should clarify this point as requested in the mandate given by the European Commission. Some respondents also pointed to the fact that EIOPA proposed in its CP to amend the prudent person principle and that ESMA should therefore follow a consistent approach under the UCITS and AIFMD frameworks. Many of the stakeholders that supported these positions expressed the view that ESMA should therefore propose amendments to the following provisions:

- Article 22 of Commission Directive 2010/43/EU on *"Duty to act in the best interests of UCITS and their unit-holders"*; and
- Article 17 of Commission Delegated Regulation 231/2013/EU *"Duty to act in the best interests of the AIF or the investors in the AIF and the integrity of the market"*.

In this context, many stakeholders argued that ESMA should more clearly spell out or give examples how authorised entities could integrate sustainability risks and factors in their due diligence processes.

38. **ESMA response:** ESMA is not persuaded by the idea that additional legislative amendments to Article 22 of Commission Directive 2010/43/EU and Article 17 of Commission Delegated Regulation 231/2013/EU would provide more benefits compared to making the requested legislative clarifications directly in the due diligence requirements set out in Article 23 of the Commission Directive 2010/43/EU and Article 18 of the Commission Delegated Regulation 231/2013/EU. Moreover, ESMA does not support the view expressed by some respondents that EIOPA's proposals to clarify the prudent person principle under Solvency II would raise consistency issues with the advice provided by ESMA. The prudent person principle set out under Article 132 of Solvency II requires insurance and reinsurance undertakings to only invest in assets and instruments whose risks can be properly identified, measured, monitored, managed, controlled, reported, and appropriately taken into account in the assessment of the overall solvency needs. Furthermore, all assets shall be invested in such a manner to ensure the security, quality, liquidity, and profitability of the portfolio as a whole. In particular, assets held to cover the technical provisions shall be invested in the best interest of all policyholders and beneficiaries taking into account any disclosed policy objective. The prudent person principle is therefore a concept with similar objectives but with different technical elements compared to the obligation set out in the UCITS Directive and AIFMD to act in the best interest of investors (as further specified in Article 22 of Commission Directive 2010/43/EU and Article 17 of Commission Delegated Regulation 231/2013/EU). In this regard, ESMA is convinced that the proposed amendments to the due diligence and risk management provisions proposed in this technical advice are the appropriate way to integrate sustainability risks in the UCITS and AIFMD frameworks.

39. Finally, some respondents saw merit in ESMA providing additional clarifications on whether the integration of sustainability risks in the investment process requires to limit the analyses to risks of a decrease in financial value of investment positions due to sustainability-related



causes or whether authorised entities should also (or rather) assess the impact of business activities of the investee companies on environment and society.

40. **ESMA response:** ESMA is of the view that the answers to these questions are of paramount importance for the overall scope and actual impact of the Sustainable Finance initiative. ESMA strongly supports the view that the transition towards a sustainable economy cannot be achieved by simply implementing a binary approach between ‘green’ and ‘brown’ assets. To this end, sustainability must be assessed in a more nuanced manner. Authorised entities’ due diligence processes are most effective where they assess sustainability both in relation to (i) risks of a decrease in the financial value or performance for the investment portfolios due to sustainability-related causes and (ii) the potential long-term impact of the investee companies’ business activities on sustainability factors. To this end, due diligence processes should not become a mere tick-box exercise but be designed as an evolving and dynamic tool able to integrate emerging risks and to identify potential and actual adverse impacts and seek to mitigate them, where possible. This includes active engagement with investee companies, e.g. through voting strategies to address material sustainability risks and achieve more sustainable outcomes, but may also include specialist research to supplement off-the-shelf data and employing investment strategies, where possible, such as exclusions (negative screening), norms-based screening, best-in-class (positive screening), sustainability themed investments or impact investing. Institutional investors such as fund managers authorised under the UCITS Directive and AIFMD already apply engagement strategies to steer the activities of the investee companies. This is the principle of stewardship by which authorised entities would act to influence the strategy and business of the companies in which they are investing in order to progress towards sustainable economic activities. This principle is already recognised in EU regulation¹⁰ and ESMA is of the view that the transition towards a more sustainable and inclusive growth should also rely on this important principle. In this context, the Disclosure Regulation clarifies that the consideration of principal adverse impacts of investment decisions on sustainability factors in the due diligence process will not be mandatory for all market participants. To this end, ESMA has added “where applicable” in the text proposed below on due diligence.
41. In light of the above, ESMA included additional wording clarifications on due diligence requirements and conflicts of interest recitals. As suggested above, ESMA encourages the Commission to perform a review of the terminology when adopting the final legislative acts in order to ensure consistency with the final outcome of the various legislative procedures.
42. Given the fact that authorised entities managing UCITS and AIFs would be subject to the operating conditions proposed hereinafter, whereas no equivalent requirements would be applicable to authorised entities providing individual portfolio management pursuant to Article 6(3)(a) of the UCITS Directive and Article 6(4)(a) of the AIFMD¹¹, the Commission is invited to give consideration to additional legislative amendments with a view to ensuring a level playing field between collective and individual portfolio management.

¹⁰ DIRECTIVE (EU) 2017/828 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

¹¹ For which pursuant to Article 6(4) of the UCITS Directive and Article 6(6) of AIFMD certain MiFID rules would apply.

Technical advice

COMMISSION DIRECTIVE 2010/43/EU

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 and self-managed UCITS investment companies should include those that may arise in relation to the integration of sustainability risks. The identification process should include, for example, conflicts arising from remuneration or personal transactions of relevant staff as well as any sources of conflicts that could give rise to greenwashing, misselling, misrepresentation of investment strategies or churning. Consideration should also be given to conflicting interests between funds with different investment strategies managed by the same UCITS management company as well as situations where there are other business-relationships with investee companies, conflicting group interests, investments in entities with close links or similar circumstances.

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

Article 23

Due diligence requirements

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, where applicable¹², the principal adverse impact of investment decisions on sustainability factors when complying with the requirements set out in paragraphs 1 to 4. Where applicable, management companies shall develop engagement strategies including for the exercise of voting rights, where available, with a view to reducing the principal adverse impact of investee companies on sustainability factors.

COMMISSION DELEGATED REGULATION (EU) 231/2013

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. The identification process should include, for example, conflicts arising from remuneration or personal transactions of relevant staff as well as any sources of conflicts that could give rise to greenwashing, misselling, misrepresentation of investment strategies or churning. Consideration should also be given to conflicting interests between funds with different investment strategies managed by the same AIFM as well as situations where there are other business-relationships with investee companies, conflicting group interests, investments in entities with close links or similar circumstances.

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

Article 18

¹² For further clarity, the Commission may want to add cross-references to the provisions set out in the final version of the Disclosure Regulation relating to disclosures of principal adverse impact that are required for authorised entities with more than 500 employees and that are based on a comply or explain mechanism for authorised entities with fewer than 500 employees. Under the compromise text published by the Council on 22 March (7571/19), this relates to Article 3gamma and Article 4gamma.

Due diligence

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, where applicable¹³, the principal adverse impact of investment decisions on sustainability factors when complying with the requirements set out in paragraphs 1 to 3. Where applicable, AIFMs shall develop engagement strategies including for the exercise of voting rights, where available, with a view to reducing the principal adverse impact of investee companies on sustainability factors.

¹³ For further clarity, the Commission may want to add cross-references to the provisions set out in the final version of the Disclosure Regulation relating to disclosures of principal adverse impact that are required for authorised entities with more than 500 employees and that are based on a comply or explain mechanism for authorised entities with fewer than 500 employees. Under the compromise text published by the Council on 22 March (7571/19), this relates to Article 3gamma and Article 4gamma.

4 Risk management

Background/Mandate

Extract from the Commission's request for advice (mandate)

“In line with the Delegated Acts adopted under Article 51(4) of the UCITS Directive, [...] Articles 15(5) and 19(11) of AIFMD [...] risk management systems or procedures for risk assessment should be in place to monitor risks to which they are exposed. Financial market participants must employ risk-management processes which enable them to measure and manage at any time the risk of the positions and their contribution to the overall risk profile. Risk assessments should consider both financial and relevant sustainability risks. The valuation processes should therefore ensure a proper degree of consideration of relevant/material sustainability risks. The technical advices should describe the elements needed to ensure that financial market participants take into account sustainability risk effectively as well as the tasks to be fulfilled by the relevant functions, such as risk management function, in this respect.

The technical advices on the amendments of the respective delegated acts should be consistent with each other, while recognizing, where relevant, the difference in terminology used by [...] the UCITS Directive, AIFMD [...]. The technical advices should map the provisions of delegated acts that should be amended.”

Analysis following the public consultation

43. The majority of respondents agreed with ESMA's proposed amendments to provisions relating to risk management. They underlined that such a principles-based approach is the preferred solution as the risk management processes of funds need to be specifically tailored to their investment strategies, the characteristics of the portfolios and the objectives of the underlying investors.
44. These respondents also agreed with ESMA's holistic approach to risk management and that sustainability risks should be included in the existing risk management systems and not be given precedence over other types of risks. Respondents stressed that a different approach could create inefficiencies and hinder the authorised entities' ability to successfully capture the interrelations between sustainability and all other risks covered by their risk management systems. Moreover, these respondents cautioned that a different approach could give rise to risk imbalances compared to other types of risks.
45. **ESMA response:** ESMA agrees that the integration of sustainability risks would be best done as suggested in the CP by including sustainability in the list of material risks to be managed pursuant to Article 38 of the Commission Directive 2010/43/EU and Article 40 of the Commission Delegated Regulation (EU) 231/2013.
46. Several respondents pointed out that given the lack of relevant and reliable data, sustainability risks are often hardly quantifiable. These respondents asked ESMA to amend the provisions in a way that would take into account the difficulties to effectively integrate sustainability risks in the risk management process.

47. **ESMA response:** ESMA acknowledges the operational challenges involved with getting reliable data on sustainability risks and factors. At the same time, ESMA points to the fact that the principle of proportionality is already clearly and sufficiently ingrained in the existing Level 1 and Level 2 risk management requirements.
48. Most respondents did not see any merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks. They agreed that the integrated risk management approach suggested by ESMA would enable them to apply a more holistic approach to integrating sustainability risks, rather than following a tick box approach to addressing risks which may be otherwise irrelevant to the strategies they operate.
49. In particular, most respondents clearly spoke out against amending or elaborating on provisions relating to the regular review of the risk management policies and systems with a view to more specifically referring to elements related to sustainability risks. These respondents pointed to the wide diversity of investment strategies, asset classes with idiosyncratic risks and therefore argued that authorised entities are best placed to know, review and recalibrate risk management processes. They also argued that the current legislative provisions related to the review of risk management already provide for a suitable regulatory framework that should also apply to sustainability risks.
50. A few respondents were expressly in favour of amending provisions to refer more specifically to sustainability in the review of the risk management policies. They justified their point of view by pointing to the difficulty to assess sustainability risks. Nonetheless, these respondents also highlighted the importance of managing sustainability risks.
51. A few respondents encouraged ESMA to specify the time horizons that need to be considered to assess sustainability risks.
52. Several other respondents saw merit in ESMA providing examples of best practices in relation to the techniques and tools to be used to manage sustainability risks.
53. **ESMA response:** ESMA agrees with the majority of respondents that further legislative amendments are not required at this stage. A more granular approach to the integration of sustainability risks in the risk management systems would raise the risks of creating regulatory imbalances and giving sustainability risks precedence over other types of risk.

Technical advice

COMMISSION DIRECTIVE 2010/43/EU

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

Article 38

Risk management policy

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.

[...]

COMMISSION DELEGATED REGULATION (EU) 231/2013

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

Article 40

Risk management policy

1. An AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIFs it manages are or may be exposed.

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.

[...]



5 Annexes

5.1 Annex I – Opinion of the Securities and Markets Stakeholder Group

ADVICE TO ESMA

ESMA Consultation Papers on integrating sustainability risks and factors in MIFID, the UCITS Directive and AIFMD.

I. Executive summary

In its comments applying to both consultation papers, the SMSG supports the work undertaken by ESMA.

The SMSG notes that the lack of agreed definitions and labels at the EU level is a substantial shortcoming and seriously hampers the implementation of a harmonized approach to sustainable finance. This should, however, not prevent firms from making progress in order to incorporate sustainability risks and factors, but should be taken into account by regulators and supervisors. In the absence of harmonized definitions, labels and taxonomy, the SMSG recommends that a public authority would publish a list of adequate labels.

The incorporation of ESG risks and factors is an evolving field and the SMSG therefore highlights (i) the need for supervisory convergence and (ii) the inclusion of a review clause in respect of regulation on sustainable finance.

The SMSG further deems it important that the proposed changes to the legislative framework should clarify how proportionality would be taken into account.

The SMSG considers that the regulatory approach should rely on firms designing an adequate compliance framework and makes several proposals in order to give guidance to firms. The SMSG finally makes a number of concrete comments and recommendations in response to the questions of the MiFID and UCITS/AIFMD consultation papers.

The SMSG would thus welcome the addition of several recitals, the publication of a list of relevant and adequate labels by a public authority and the inclusion of a review clause.

1. Overarching comments

1. The SMSG reiterates the comments made in its advice on Sustainable Finance of September 2018 (ESMA22-106-1301) and which are recalled in the ESMA CPs.
2. The SMSG considers that there is a strong political commitment across Europe to make good progress on integrating sustainability risks and factors in European financial legislation. While it seems that the EU is willing to make progress on its own without waiting for a global converging regime, coordination should be sought between the European Member States. Greater awareness of the importance of this issue is also required amongst global regulators as ultimately sustainability is a global issue and should be implemented globally. The SMSG notes that ESMA has performed an in depth work, particularly with regard to these two consultation papers, in a very tight timeframe. The SMSG is keen to support this move.
3. The SMSG also supports the efforts of ESMA and EIOPA to ensure consistency across sectors in respect of the integration of sustainability into the regulatory framework. The SMSG urges ESMA to continue such efforts after the consultation phase. Especially in areas such as product governance and suitability, where the regulatory framework of MiFID II and IDD is largely aligned, it is important that amendments to the regulatory framework to implement sustainability, do not lead to unnecessary differences.
4. The SMSG wishes to underline three characteristics and to make accordingly recommendations that should be taken into account in order to foster an adequate, ambitious and scalable regime.

a) The lack of agreed definitions and labels at the EU level is a substantial shortcoming and seriously hampers the implementation of a harmonized approach on sustainable finance. 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.
5. The lack of agreed definitions and labels at the EU level led to vivid and rich debates within the Group.
6. The SMSG is of the opinion that in order to prescribe conduct of business rules and to issue guidelines to financial services providers on how to integrate sustainability risks and factors into their activities, the EU needs one common and clear set of definitions and classifications to determine which are the ESG compatible (or not) economic activities. Only a clear and concise taxonomy that is built on a harmonised list of sustainability indicators - and designed by relevant experts (scientists such as physicists and biologists) - provides for a predictable and stable regulatory system which in turn is of utmost importance to foster private sector involvement in sustainable finance and to prevent harmful divergences, confusions and misconceptions. With its large and diverse scope, a taxonomy for E, S and G cannot be left to self-regulation or “best practices”, but must be established through directly applicable, binding provisions at Union law level in order to avoid diverging application of law.

7. The SMSG would indeed have much preferred the adoption of a clear and appropriate taxonomy and labels before investment firms, institutional investors and assets managers were requested to disclose how they integrate sustainability risks in the investment decision-making process or advisory process.
8. A lack of common taxonomy has obviously several negative impacts: notably:
 - It could lead to the development of products claiming incorrectly to be sustainable, leaving the investor with misleading guidance as to whether they incorporate environmental, social and corporate governance factors in their investment processes;
 - A lack of clarity and/or multiplicity of approaches may also lead to misunderstandings, as well as frustrated expectations (“how” rather than “whether” factors are incorporated);
 - It can also be a source of litigation between clients and investment firms/funds;
 - The conjunction of the European pro-active approach on sustainable products and of multiple labels and uneven stages of development could undermine risk-assessment and comparability for investors, **and create a risk of crowding or bubble effects within certain asset-classes;**
 - Beyond the product offerings, a plethora of labels and approaches as well as an uneven degree of maturity across Europe in respect of the social and governance factors may also have an impact on available skills and resources, training, and controls;
 - As many labels are national and do not necessarily benefit from a framework of accepted common criteria, it prevents to a certain extent the development of pan-European products and the export of EU products into non-EU jurisdictions.
9. The SMSG also considered that if the activity-based taxonomy and eco-labeling are critical to providing common standards for sustainability assessment, they are likely to be supplemented by consideration of other criteria such as company policy and practices which can be an important differentiator of sustainability (such as “best in class” analysis which incites ESG-friendly policies).
10. The SMSG noted that agreeing on a taxonomy will be a long journey and that as underlined by ESMA, the “Environmental” criteria are much more advanced than the “Social” and “Governance” ones. Meanwhile, the SMSG acknowledges that ESMA has been given a mandate by the Commission to come up with changes to the legislative framework, before an EU-wide harmonized taxonomy is in place. As extensively explained above, the SMSG is of the opinion that this is not the optimal way forward. If ESMA would nevertheless decide to deliver on its mandate and already put a number of requirements on investment firms and investment funds relating to sustainable finance before a harmonized taxonomy is in place, as the ESMA consultation paper suggests, the SMSG is of the opinion that in such a case it is necessary that a list of relevant and adequate labels should be published.

11. In order to achieve the objective of promoting a more sustainable economy through the financial sector, and in the absence of a harmonized taxonomy, publishing a list of relevant and adequate labels would indeed provide a hugely useful tool, particularly for smaller firms that do not have an extensive expertise in that domain but would nevertheless be obliged to comply with the sustainability standards which ESMA proposes to introduce and may be keen to be part of this trend and to maintain their competitive rank in their marketing efforts. It is important to take into account that ESG cover a number of concepts that are external to financial markets and thus, investment firms and investment advisors cannot be all supposed to handle them with technical knowledge in the absence of an official taxonomy or published list of relevant and adequate labels.

Such a list would have to be published by a public authority, preferable an EU authority, subject to severe quality checks and a robust approval process.

12. The SMSG has noted that a two-step approach focusing firstly on the environmental factors and then on the social and governance factors of ESG may lead to an unbalanced capital allocation, i.e. to more investment in environmentally sustainable projects, leaving investments for social and governance-oriented initiatives on the side. Environmental and Social or Governance factors are not mutually exclusive; quite on the contrary, they tend to go hand in hand: namely, Governance risks may lead to social risks and/or environmental risks. However, in order to align the new rules on the currently existing environment, the European regulator and national competent authorities need to acknowledge the different stages of development of “E”, “S” and “G”. If ESMA would decide to proceed with the adaptation of the legislative texts before a taxonomy is adopted, the SMSG would welcome the addition of a recital to this end in order to encourage firms to incorporate progressively these three aspects, in a manner which is transparent to clients and investors. It is important that regulation directs issuers towards a progressive increase in the amount and quality of non-financial information disclosure, which in turn will promote a data-driven and transparent framework for investment firms, so as to be ready for the newer scenario of increased investor appetite for “sustainable” assets.

b) The incorporation of ESG risks and factors is an evolving field.

13. The SMSG supports the view taken by ESMA in its presentation of the Approach to the Commission's request that the integration of sustainability risks and factors is better done through a high-level principles-based approach for the reasons explained in the CPs. The SMSG is keen to see this approach reflected in the specific wording that would be used to amend the existing regulations. The contemplated amendments to the rules should reflect both a "top down" (ESMA driving the industry to enhance practices) and a "bottom up" approach (firms choosing to adapt as they deem adequate).
14. A clearer distinction between sustainability as a risk factor – relevant to all investments and financial institutions - and the "sustainability factors" – relevant to the products that have an ESG objective should be made.
15. In practice, whether relying or not on existing ESG market standards or labels, ESG product manufacturers' main challenge remains data availability. Manufacturers rely on a variety of external ESG data providers (which do not necessarily have harmonized methodologies and capture a mixed of quantitative and qualitative information from multiple sources, subject to their availability, such as tax declaration, social and economic assessment, income statements, questionnaires sent directly to companies or meetings organized with the different companies 'stakeholders etc.). The reality is that a limited number of companies issue clear, usable and standardized data on the sustainability of their activities and strategy/conduct. Although recognising that incorporating ESG considerations in the due diligence requirements is a positive step regarding the awareness of actors, the SMSG outlines that in the absence of a generally applicable and harmonized taxonomy, this can only be done successfully "where possible", i.e. when quality information from issuers is available.
16. From a broader standpoint and taking example on ESMA's work on the credit rating agencies CP, ESMA's recommendations should carefully avoid suggesting for instance that the consideration of ESG factors would systematically be relevant or more relevant than the consideration of classical financial factors and risks either to the portfolio management or to the client advice.
17. The SMSG highlights that for the purpose of risk assessment sustainability is a contributing factor which should be integrated into firms' existing risk analysis frameworks. Analysis of sustainability factors can improve or degrade the outlook for credit risk, liquidity risk, reputational risk etc which are already part of firms' risk analysis frameworks. ESMA should ensure that sustainability factors are appropriately integrated into risk analysis processes, but should not be prescriptive with regard to methodology.

18. The SMSG wishes to emphasize that the diversity of models and frameworks in the risk analysis process is the operational consequence of high level principles; diversity of approaches should be preserved so as to foster innovation and appropriateness in the manner of dealing with sustainably factors; this should be acknowledged in a recital. The SMSG discussed whether “E”, “S” and “G” sustainability risks should be considered separately or together with other risks in a coherent set and concluded that, while there is no clear evidence that the former or the latter approach is better, optionality should be the rule.
19. As acting in the best interest of the investors is an overarching principle, the investor’s perspective should also be the focus of attention when implementing sustainability considerations in MiFID2, the UCITS directive and AIFMD. The investor needs fair, clear and not misleading information about ESG considerations when making an investment decision. Some members highlighted that understanding investors ESG profile and preference is, at this stage of “market development” very difficult and likely not stable, while trying to quantify them seems almost impossible.
20. In order to take into account the above comments, it seems that
- firms should establish (and periodically review) policies and procedures in order to comply and they should explain how they consider that these policies and procedures fit with clients’ and supervisors’ expectations,
 - best practices should be reviewed by NCAs and by ESMA periodically and at least 2 years after the implementation date in order to “enact” progress made.
21. While a “review clause” and avoiding too many “must have” would avoid creating regulatory risk and enable an evolution in practices, the use of recitals could provide the additional clarity and guidance needed for a “top down” perspective, for instance:
- the SMSG noted that the available resource/ expertise / technical skills will increase over time, but are currently scarce compared to the scope and number of firms that would have to implement these changes. The SMSG would welcome an explicit reference in the draft RTS to the need to train relevant investment firm staff on ESG expertise, which requires time to implement on such a large scale.
 - While implicit in the CPs, the flexibility provided by outsourcing and external advice/support needs to be explicitly acknowledged, and encouraged, in order to allow smaller firms to be able to comply with the evolving market standards and European rules on sustainable finance. For instance, firms could explain why and how they have chosen an external provider, what is expected of them and how the service is reviewed/ assessed.

- The principles-based approach on the one hand gives companies sufficient scope to implement the measures, but on the other hand carries the risk of "greenwashing". This makes it all the more important for companies to document the internally agreed framework, policies and procedures, measures taken and the set of indicators used to measure their effectiveness vis-à-vis the supervisory authorities and the clients and investors. Internal independent control / 2nd and 3rd "lines of defense" being in charge of monitoring and testing compliance with policies and procedures, a breach of these could potentially lead, if material and/or repeated enough, to a regulatory breach.

c) Proportionality

22. Smaller firms are very likely to struggle from a cost perspective with the impact of the new rules (access to resources, training, documentation, disclosures, controls and testing). Regulators and supervisors should be particularly cautious that smaller independent firms are not driven out. As proportionality is a cornerstone of the Commission's better regulation policy, the SMSG would recommend that ESMA reaffirms the proportionality principle and where possible clarifies in a recital for instance how proportionality could be applied depending on the size, nature, scale and complexity of their activities. For instance, the proportionality principle is reminded in the ESMA explanatory text in the AIFM/UCITS consultation, but is not reflected in the proposed amendments.
23. Application of proportionality should take into account that the expression "where relevant" is a cornerstone to adapt the new ESG requirements to the cases where it must be applied. "Where relevant" applies not only to specific products but also to clients' needs and demands.
24. Proportionality, together with flexibility should lead each investment firm to define the ESG criteria they apply, following an already existing label or not.

d) In the context discussed above, the ESMA Supervisory Convergence Work Programme is seen as an effective way to promote an evolutive and consistent approach of the integration of ESG factors and risks.

25. The SMSG notes that ESMA has identified Supervisory Convergence as a strategic priority for 2016-2020. Fostering a closer dialogue between supervisors across the EU on their local respective market practices, regulatory approaches and supervisory findings relating to sustainability would enable to make progress towards "consistent best standards" together with maintaining proportionality. While further guidance will be welcome in order to reduce regulatory uncertainty and achieve convergence, the SMSG stresses the importance of an adequate public consultation before these are published.



[...]

3. UCITS and AIFMD Consultation Paper (ESMA34-45-569)

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?

1. The SMSG notes that

- each organization is different and should be able to carry out their own meaningful set up depending on the size, nature, scale and complexity of their activities,
- this requirement can also be challenged from a proportionality standpoint,
- the integration of sustainability risks and factors should be part of the clear definition of roles and responsibilities within a firm.

2. Nevertheless, the SMSG agrees that in order notably to ensure the awareness of the senior management and leadership on this sensitive topic, a person or function responsible for the integration of sustainability risks and factors should be identified. If such a requirement is introduced, ESMA should make clear that this requirement should be applied proportionally: this person should not be required to have an “established” expertise and should not dedicate 100% of his or her time to this task. The term “qualified” should therefore be deleted.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

Adopted on March 6th, 2019

Veerle Colaert
Chair
Securities and Markets Stakeholder Group

5.2 Annex II – Cost-Benefit Analysis

Background

1. Sustainability has since long been at the heart of the European project. The EU Treaties give recognition to its social and environmental dimensions. The 2016 Commission's Communication on the next steps for a sustainable European future links the Sustainable Development Goals (SDGs) of the UN 2030 Agenda for Sustainable Development to the European policy framework to ensure that all EU actions and policy initiatives, within the EU and globally, take the SDGs on board at the outset. The EU is also fully committed to reaching the EU 2030 climate and energy targets and to mainstream sustainable development into EU policies. Consequently, many of the Commission's policy priorities for 2014-2020 feed into the EU climate objectives and implement the 2030 Agenda for Sustainable Development.
2. Following the mandate received from the Commission by the end of July 2018 and after the public consultation that took place from December 2018 to February 2019, ESMA is now providing this Technical Advice to the Commission in order to fulfil the request of advice on potential amendments to, or introduction of, delegated acts under the UCITS Directive and the AIFMD with regard to the integration of sustainability risks and sustainability factors in internal processes and procedures of UCITS management companies and AIFMs.
3. Since this Final Report is limited to the topics included in the Technical Advice to the Commission, the preliminary CBA is updated accordingly and considers the responses received to the CP on the level of resources that would be required to implement and to comply with the proposed provisions on organisational requirements, operating conditions and risk management.
4. With regard to organisational requirements, ESMA is proposing changes in the following areas of the UCITS and AIFMD frameworks:
 - Article 4 of the Commission Directive 2010/43/EU on "General Requirements on Procedures and Organisation"
 - Article 5 of the Commission Directive 2010/43/EU on "Resources"
 - Article 9 of the Commission Directive 2010/43/EU on "Control by Senior Management and Supervisory Function"
 - Article 22 of the Commission Delegated Regulation (EU) 231/2013 on "Resources"
 - Article 57 of the Commission Delegated Regulation (EU) 231/2013 on "General Requirements"
 - Article 60 of the Commission Delegated Regulation (EU) 231/2013 on "Control by the Governing Body, Senior Management and Supervisory Function"

5. With regard to operating conditions, ESMA is proposing changes in the following areas of the UCITS and AIFMD frameworks:
 - Article 18 of the Commission Delegated Regulation (EU) 231/2013 on “Due Diligence”
 - Article 23 of the Commission Directive 2010/43/EU on “Due Diligence Requirements”
6. With regard to risk management, ESMA is proposing changes in the following areas of the UCITS and AIFMD frameworks:
 - Article 38 of the Commission Directive 2010/43/EU on “Risk Management Policy”
 - Article 40 of the Commission Delegated Regulation (EU) 231/2013 on “Risk Management Policy”

The impact of the proposed changes

7. In line with the European Union’s commitment for a sustainable development as pointed out in the package of measures on Sustainable Finance adopted by the Commission in May 2018, this Technical Advice suggests changes to the UCITS Directive and AIFMD Level 2 frameworks to accomplish the Commission’s mandate received by ESMA in July 2018 aiming at integrating sustainability risks and factors in the investment decisions and the internal processes of authorised entities.
8. As stated in the CP, only a qualitative cost-benefit analysis can be provided in relation to the changes identified in this Technical Advice. Some respondents to the CP provided qualitative information on the level of resources that would be required to implement and to comply with the suggested changes and in a very few cases also quantitative estimations were illustrated although the data presented were too limited and incomplete to be considered fully representative of the market.

Benefits

9. The proposed changes will provide clarity on how UCITS management companies and AIFMs are required to assess sustainability risks and to take them into account when making investment decisions. This will improve the quality of the services provided by ensuring:
 - a more adequate risk management by authorised entities enhancing the risk-adjusted performance of their products benefitting end-investors, particularly over the long-term;
 - a coherent approach across sectors and Member States with regard to the integration of sustainability risks by covering, among others, the areas of governance, operating conditions and risk management.

10. In addition, the integration of sustainability risks and factors in UCITS management companies' and AIFMs' processes might attract new investors and increase trust in the financial system, as a consequence. Evidence mentioned in the Impact Assessment presented by the European Commission suggests that the markets will reward companies that come up with innovative approaches to address ESG factors.¹⁴
11. Moreover, it is worth mentioning that taking sustainability risks into account will make UCITS management companies and AIFMs more resilient to adverse scenarios that might impact sectors vulnerable to e.g. climate change, or leave these companies with stranded assets. This will undoubtedly create long-term value for both firms and investors, as pointed out by several respondents.

Costs

12. Most respondents expressed the view that the level of resources required will essentially depend on the nature of the firm, its size, business model, its investment process and how advanced is the integration of sustainability risks and factors in the various processes. Several respondents also noted that the costs would vary according to the prescriptiveness of the final legislative measures and the existence of specific national requirements. For instance, if integrating sustainability required additional policies/resources, the costs entailed would be much higher than if existing risk management policies and resources simply needed some enhancements. For these reasons, respondents deemed impossible to estimate at this stage the level of (financial and other) resources that would be required to implement and to comply with the proposed changes.
13. Nonetheless, the costs of integrating sustainability risks in authorised entities' internal processes, including their investment decisions, are expected to remain relatively limited. Authorised entities that have not already integrated sustainability risks within their processes, will need to invest (financial) resources to obtain relevant expertise, data and tools in order to do so. As also explained in the Impact Assessment provided by the Commission¹⁵, the feedback received from stakeholders during targeted interviews suggests that these costs should be limited.
14. In particular, the need for authorised entities to hire new staff did not emerge as a substantive issue. It is rather a question of investing more systematically in relevant expertise (e.g. employee and board-member training), data and tools. Depending on the current level of integration of sustainability risks, this could also involve buying relevant data from third-party vendors, more systematic integration in the investment decision process and risk assessment, and possible further task-specialisation and more active engagement with companies on topics related to sustainability risks and factors.
15. In the preliminary CBA provided in the CP, ESMA noted that the potential and incremental costs that firms will face when reviewing and updating internal processes and procedures

¹⁴ Commission Staff Working Document, Impact Assessment (SWD(2018) 264 final), page 53.

¹⁵ See Commission Staff Working Document, Impact Assessment (SWD(2018) 264 final, page 42).

in order to integrate sustainability risks might be both one-off and ongoing, arguably linked to: a) direct costs linked to the update/review of the existing procedural and organisational arrangements b) direct initial and ongoing IT costs to update current structures and programs; c) direct relevant organisational and HR costs linked to the qualification of firm staff or training for board members; d) (possibly, depending on current arrangements of authorised entities) direct and on-going costs for buying relevant data from third-party vendors; e) initial and on-going costs for reviewing and updating existing risk management and due diligence arrangements.

16. Respondents to the CP broadly supported the identification of the potential sources of costs identified by ESMA and in some cases pointed out the importance of costs for research and data.

Conclusion

17. Specifying the consideration of sustainability risks in organisational requirements, operating conditions and risk management serves the purpose of avoiding different approaches across market participants and Member States. It is therefore possible to conclude that the approach followed in this Technical Advice by ESMA will increase consumer protection and ensure a level playing field among financial market participants.
18. ESMA is of the view that the principles-based approach adopted in the Technical Advice is able to achieve the policy goals relating to an effective integration of sustainability risks in the UCITS Directive and AIFMD on the one hand, while on the other hand reducing the required implementation costs by authorised entities, e.g. by allowing for an integrated risk management approach. ESMA believes that the suggested changes are proportionate in terms of costs for authorised entities, as they appear to require limited investment in relevant expertise, data and tools. The changes will achieve the intended objective of fulfilling the Commission's mandate without imposing unnecessary burden on market participants.
19. Therefore, the benefits of such approach are expected to be higher than the potential costs, also due to the adoption of harmonised requirements that would ensure more clarity and a coherent approach across the EU as regards the integration of sustainability risks by authorised entities.