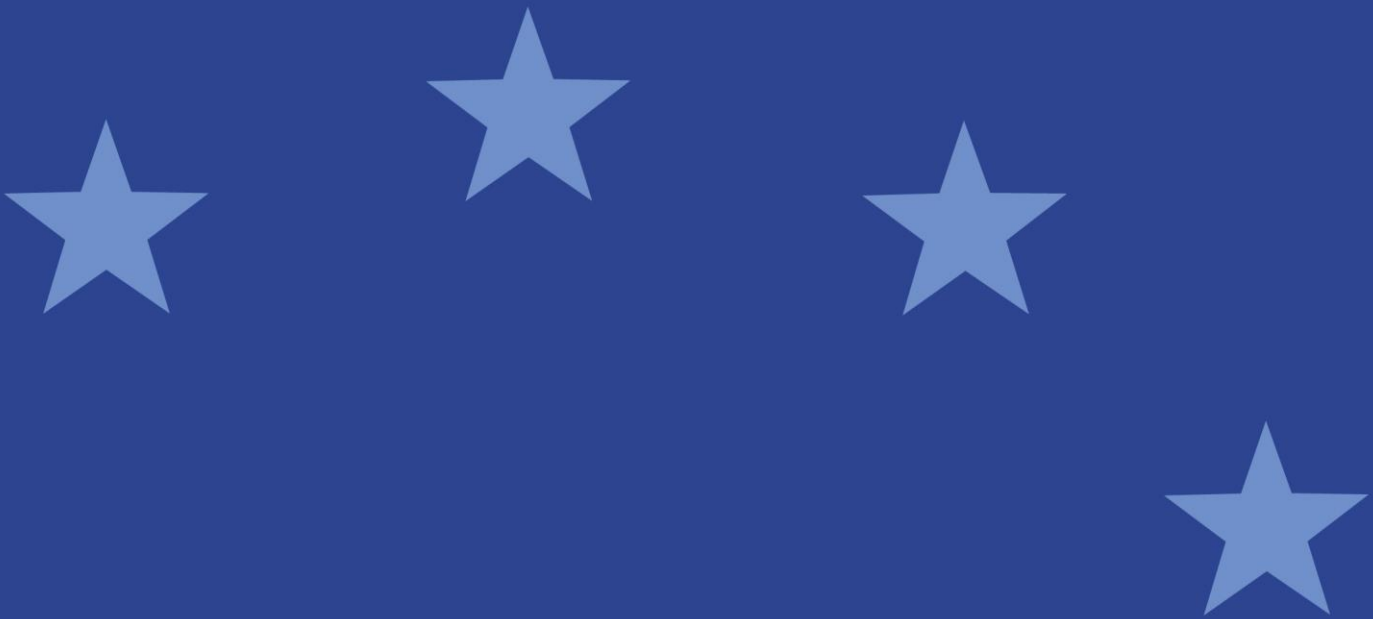




European Securities and  
Markets Authority

# Final Report

**ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II**





European Securities and  
Markets Authority

30 April 2019  
ESMA35-43-1737



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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; creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.
3. In addition, in January 2019 the Commission has published draft rules on how investment firms and insurance distributors should take sustainability issues into account when providing advice to their clients. These include amended delegated acts under the Markets in Financial Instruments Directive (MiFID II)<sup>1</sup> and the Insurance Distribution Directive<sup>2</sup>.
4. Furthermore, during the finalisation of this technical advice, co-legislators have reached political agreement on a new Regulation setting out disclosure requirements on sustainable finance (hereinafter 'Disclosure Regulation').<sup>3</sup> Due to the timing of the political agreement, and the content of the original mandate received from the Commission in July 2018, ESMA could not fully consider the recently approved Disclosure Regulation in the public consultation process of this technical advice. ESMA notes however that, beyond the changes suggested by ESMA in light of the mandate received, some further changes to the MiFID II delegated acts might be needed in light of the new requirements introduced by the Disclosure Regulation. For example, an amendment might be introduced in Article

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<sup>1</sup> [https://ec.europa.eu/info/law/markets-financial-instruments-mifid-ii-directive-2014-65-eu/amending-and-supplementary-acts/implementing-and-delegated-acts\\_en](https://ec.europa.eu/info/law/markets-financial-instruments-mifid-ii-directive-2014-65-eu/amending-and-supplementary-acts/implementing-and-delegated-acts_en)

<sup>2</sup> [https://ec.europa.eu/info/law/insurance-distribution-directive-2016-97-eu/amending-and-supplementary-acts/implementing-and-delegated-acts\\_en](https://ec.europa.eu/info/law/insurance-distribution-directive-2016-97-eu/amending-and-supplementary-acts/implementing-and-delegated-acts_en)

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

54(9) of the MiFID II Delegated Regulation, to clarify that, where applicable, firms subject to the Disclosure Regulation should consider, taking due account of their size, nature and scale of their activities and types of their financial products, the principal adverse impact of investment decisions on sustainability factors.<sup>4</sup>

## Public consultation

5. On 19 December 2018, ESMA published a Consultation Paper (CP)<sup>5</sup> on the draft technical advice on integrating sustainability risks and factors in MiFID II in order to explain its rationale and gather input from stakeholders. The consultation period closed on 19 February 2019.
6. ESMA received 69 responses, 2 of which on a confidential basis. The answers received are available on ESMA's website unless respondents requested otherwise. ESMA also received the advice of the Securities and Markets Stakeholder Group's (SMSG).<sup>6</sup>
7. The responses to the public consultation and the SMSG included some general comments that are summarised below:

- Overall, a majority of respondents agreed with ESMA's principled-based approach to integrating sustainability risks and factors in MiFID II 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 and 3 of this FR.

- Various respondents noted that concepts and terms relating to environmental, social, and governance matters should be clearly defined. Respondents noted that some definitions are included in the Commission's amendments to the MiFID Delegated Regulation, which were drafted in parallel to ESMA's CP. However, these respondents highlighted the absence of a common definition for important concepts such as 'sustainability risks'. These respondents underlined the importance to have a shared understanding of terms such as this in order for firms to understand how these proposed amendments would work in practice. On this topic, 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*

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<sup>4</sup> The suggested amendment in Article 54(9) of the MiFID II Delegated Regulation could be introduced in order to align MiFID II with the requirements imposed by Articles 3gamma and 4gamma of the Disclosure Regulation (under the compromise text published by the Council on 22 March (7571/19)).

<sup>5</sup> ESMA35-43-1210.

<sup>6</sup> See Annex I of this FR.

*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.”*

**ESMA response:** ESMA agrees on the importance of having clarity on the terminology used for the correct implementation of the new requirements. ESMA also believes 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 definitions on these topics are indeed included in the new rules on sustainability-related disclosure requirements related to sustainable investments and sustainability risks on which the co-legislators have recently reached political agreement.<sup>7</sup>

- 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, which also included a consumer association, stated that a clear and compulsory taxonomy should be established, and it should address all three dimension 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 a 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;*
  - *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*

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<sup>7</sup> The Disclosure Regulation includes, amongst others, definitions of “sustainability risk”, “sustainability factors” and “sustainable investments”.

*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.”*

Further, more detailed comments on possible approaches to be followed until an EU taxonomy and labelling system is finalised are included in Chapter 3 of the FR.

Please refer to that Chapter for the ESMA views on this issue.

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

**ESMA response:** ESMA agrees on the need for supervisory convergence in this area and has therefore initiated updates to two sets of guidelines on the topics impacted by changes in the MiFID II delegated acts. ESMA also noted that this advice does not preclude further supervisory convergence work in this area (through Q&As and/or guidelines, including those for the assessment of knowledge and competence).

ESMA also agrees on the opportunity to assess and review, in due course, the amendments introduced in the MiFID II delegated acts on the topic of sustainable finance.

- 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 MiFID II proposed amendments and the changes proposed with reference to the UCITS, AIFMD and IDD framework.

**ESMA response:** ESMA agrees, and in this respect, 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 terminology aligned to the one included

in the legislative proposals or adopted legislation on sustainable finance<sup>8</sup>. 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.

**ESMA response:** ESMA agrees that firms should be given sufficient time to implement the new requirements. However, ESMA notes that the adoption of the updated MiFID II delegated acts by the Commission will be followed by a 3 to 6 months objection period by the European Parliament and the Council and then a 12 months delay for their entry into application. The above timing seems compatible with what is requested by respondents and should allow sufficient time to firms to plan and implement the regulatory changes. Furthermore, as highlighted multiple times in this Final Report (FR), the principle-based approach suggested by ESMA in its technical advice should allow firms to adapt their organizations more gradually, reducing costs related to the review of processes and systems.

- 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 changes introduced through the draft technical advice should all be applied by firms with the proportionality principle in mind, taking into account the size, nature, scale and complexity of their activities. ESMA however believes that this principle is already clearly engrained in the second subparagraph of Article 21(1) of the MiFID II Delegated Regulation and therefore does not need to be re-affirmed in a new recital.

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<sup>8</sup> 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’.





8. The specific comments raised on the various sections of the CP are summarised in the 'Analysis' section of the subsequent Chapters 2 and 3 of this FR.
9. Finally, it is important to note that the CP also included suggested amendments to the ESMA guidelines on MiFID II product governance requirements<sup>9</sup> and the ESMA guidelines on certain aspects of the MiFID II suitability requirements<sup>10</sup>. ESMA intends to finalise the updates to these guidelines only after the updated MIFID II delegated acts have been approved (see Next Steps below). All comments on the draft guidelines received during the public consultation will be summarised and addressed subsequently within the FR on the updated guidelines.

### **Cost-benefit analysis**

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

### **Contents**

11. This FR covers the topics on which the Commission has requested ESMA to provide technical advice, namely: organisational requirements; risk management; conflicts of interest; product governance.

### **Next steps**

12. ESMA will deliver its technical advice to the Commission which should then adopt updated MiFID II delegated acts. Once adopted by the Commission, the delegated acts will enter into force after their publication in the Official Journal, unless the European Parliament and the Council object to them within a period of three months (extendable to six months).

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<sup>9</sup> Ref: ESMA35-43-620.

<sup>10</sup> Ref: ESMA35-43-869.

## 2 Organisational requirements

### Background/Mandate

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

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:

- 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

##### *General organisational requirements*

1. The majority of respondents agreed with ESMA's view that the integration of sustainability risks within the MiFID II requirements is better done through a high-level principle-based approach similar to that already followed for all other relevant risks (e.g. credit risk, market risk, liquidity risk). These respondents noted that considering that several Commission legislative proposals are still not yet finalised, too prescriptive requirements in relation to sustainability risks may result in potential regulatory inconsistencies and subsequently in legal uncertainty.

2. Respondents who supported ESMA's suggested approach, noted that it would enable firms to adapt their organizations more gradually, reducing costs related to the review of processes and systems and the legal uncertainty of continuous or disproportionate changes.
3. Finally, various respondents agreed with ESMA that staff involved in the advisory process should possess skills, knowledge and expertise for the assessment of sustainability risks. In this regard, some respondents encouraged ESMA to update its MiFID II guidelines for the assessment of knowledge and competence<sup>11</sup> in order to ensure a harmonised approach across Member States.
4. Some of the respondents that disagreed with ESMA's proposed amendments to Article 21, noted that the amendment could be misunderstood to mean that ESG factors might be assigned more importance than other factors. These respondents expressed the view that no change is needed to MiFID's general organisational requirements and that instead the most appropriate approach would be to only modify the specific requirements (for example: product governance) where firms need to integrate ESG considerations. Conversely, other respondents instead disagreed with the suggested approach because they believe ESMA should propose in the MiFID II Delegated Regulation more detailed and stringent requirements in this area.
5. **ESMA response:** ESMA acknowledges the comments received but has decided to confirm the content of the technical advice with the suggested amendment to Article 21 of the MiFID II Delegated Regulation. In this respect ESMA believes that, as noted by the majority of respondents, the suggested approach is balanced and is consistent with the Commission's mandate without introducing disproportionately detailed requirements.
6. Various respondents however encouraged ESMA to provide more guidance on how to apply the proposed new requirement and, more specifically, what it means that ESG considerations should be taken into account when complying with all the other requirements in Article 21.
7. **ESMA response:** ESMA confirms that, considering the importance of the topic of sustainable finance and 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 (through Q&As and/or guidelines, including those for the assessment of knowledge and competence).
8. Furthermore, some respondents noted that, in line with the Commission's mandate, ESMA should clarify that the amendments to Article 21 only apply to firms providing the services of 'portfolio management' and 'investment advice'. Similar comments on scope were raised on other sections of the draft technical advice. On this same topic, the SMSG asked ESMA to specify in a recital the investment services to which this rule applies.

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<sup>11</sup> Ref: ESMA/2015/1886.

9. **ESMA response:** ESMA notes that the Commission’s mandate included a request for technical advice on topics such as product governance which apply to investment firms irrespective of the type of product or service provided. In light of this, ESMA believes that it would be incorrect to limit the application of the amendments suggested to Article 21 only to firms providing portfolio management and/or investment advice. ESMA however recalls that Article 21 of the MIFID II Delegated Regulation has ingrained the principle of proportionality as it states that *“When complying with the requirements set out in [paragraph 1], investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business”*. As acknowledged by many respondents, ESMA has also taken into account this issue, by specifying that firms should take ESG considerations into account only where they are relevant.
10. Finally, the SMSG stated *“the new paragraph should be put before the current last paragraph on proportionality (in regard of the nature, scale and complexity of the business and the nature and range and activities). By placing the new paragraph before the proportionality paragraph, the proportionality paragraph would also apply to the new requirement in regard to sustainability”*.
11. **ESMA response:** ESMA agrees and has made the suggested change.

#### *Risk management*

12. The majority of respondents and the SMSG were supportive of the suggested changes to Article 23 of the MiFID II Delegated Regulation. These respondents noted that the data available to firms on sustainability risks is still very limited and imperfect and that therefore, at this stage, amendments to risk management requirements must allow flexibility for wider qualitative considerations to be taken into account, and that firms should not be over reliant on the services of unregulated data providers.
13. On the other hand, some respondents noted that Article 23 relates to all risks, without providing any examples and that other risks, like credit risk, operational risk, reputational risk, are not explicitly mentioned. These respondents noted that firms should be free to choose how to assess ESG risks and the impact they have on their businesses and clients. Some respondents highlighted that the taxonomy will be of limited help to assess ESG risks, as it will ‘only’ define a list of sectors/activities, in respect of the ESG dimensions.
14. **ESMA response:** ESMA confirms that the methodology used to assess sustainability risks is not prescribed in the text of the technical advice.
15. Some respondents also noted that further guidance should be provided on how to implement the changes to Article 23.
16. Diverging comments were raised on the paragraph of the Consultation Paper stating *“ESMA would like to emphasize that, through the inclusion of a reference to ESG considerations in Article 23 of the MiFID II Delegated Regulation, it would also be expected that both the Compliance function and Internal Audit will consider issues related to*

*sustainability risks, as both functions are responsible of monitoring the adequacy and effectiveness of the firms' risk management policies and procedures*". Some respondents noted that firms can best assess themselves which internal business unit (be it either audit, compliance or another business unit) should ascertain sustainability risks. Others instead stated that ESMA should include amendments to the the MiFID II Delegated Regulation provisions relating to internal audit and compliance functions so as to accommodate sustainability considerations in these fields as well.

17. **ESMA response:** ESMA has decided to confirm the content of its advice on this topic as it considers that the explicit referral to the sustainability risks in Article 23 of the MiFID II Delegated Regulation is consistent with the Commission's mandate to require firms to integrate sustainability risks within their risk management systems and procedures. In order to ensure clarity and convergence, ESMA has also decided to suggest the addition of a new recital. The new recital confirms the position expressed in the Consultation Paper that both the Compliance function and Internal Audit are expected to consider issues related to sustainability risks. The new recital also refers to the responsibilities of firms' Senior Management in order to align the content of ESMA's advice on MiFID II with that of ESMA's advice on UCITS/AIFMD.
18. The SMSG stated that it *"understands that firms are required to adopt an internal framework designed to incorporate ESG risks and factors where relevant and to ask their clients about their preferences but they are not required to offer products or investment advices/ portfolio management that are ESG 'driven'; this might be recalled in a recital"*. ESMA confirms that the technical advice is not drafted in order to require firms to offer sustainable investments, but believes that the addition of a specific recital on this point is not necessary.
19. The SMSG and several other respondents also recommended that *"the terms 'where relevant' be included in the added paragraph of Article 23, in order to acknowledge that not all products have an ESG focus"*.
20. **ESMA response:** ESMA notes that the text of the technical advice is general enough to allow a flexible approach as it requires firms to *"take into account"* sustainability risks. ESMA has therefore decided not to modify the content of the technical advice on this issue. Only wording adjustments were made.

#### *Conflicts of interest*

21. Diverging comments were raised on ESMA's proposal to add a recital, in the MiFID II Delegated Regulation, on the topic of 'conflicts of interest', in order to clarify that when identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that stem from the distribution of (i) investments in companies that adopt environmentally sustainable practices, are socially responsible, and/ or have good corporate governance; or (ii) financial instruments that provide exposure to sustainable investments, social investments, and/or good governance investments.

22. The SMSG supported the wording of the proposed recital, and suggested to explicitly add the examples mentioned in paragraph 13 of the CP in the recital.
23. The majority of respondents representing market participants (for example: trade associations, investment firms and asset managers), while supporting the principles stated by ESMA, stated that the suggested recital is unnecessary and should therefore be deleted. These respondents noted, for example, that they are not aware of conflicts of interest linked to sustainability risks or that ESG products can – by nature – be more costly than their non-ESG equivalents, related for instance to the cost of ESG screenings and scoring of underlying stocks. Such factors should not be material and should not be seen as a conflict of interest or, as ESMA describes it, as “*an excuse to sell own-products or more costly ones*”.
24. Conversely, other respondents (including the consumer associations replying to the public consultation) either supported the proposed recital, or suggested stronger measures, such as the inclusion of a new article in the MiFID II Delegated Regulation. These respondents noted it is important to draw firms’ attention to potential conflicts of interests in this area, and that these conflicts should be managed by ensuring appropriate checks and balances. Concerns were raised in the response about potential for mis-selling practices or misrepresentation, which can damage investors and also damage confidence in the industry.
25. Some respondents stated, that if the suggested approach is confirmed, it would be preferable to simply amend recital 59 of the MiFID II Delegated Regulation, instead of introducing a separate recital.
26. **ESMA response:** ESMA believes that:
- Considering the replies received and the SMSG advice, it is important to introduce in the MiFID II Delegated Regulation a clear reference to the need for firms to identify conflicts of interest whose existence may damage the interests of a client, and that in doing so such firms should include those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments.
  - The use of a recital seems a balanced approach in order not to give excessive prominence, within the content of Article 33 of the MiFID II Delegated Regulation, to the topic of sustainable finance over other sources of conflicts of interest.
  - The suggestion to simply amend the content of existing Recital 59 of the MiFID II Delegated Regulation cannot be accepted as Recital 59 focuses on ‘placing’ while the suggested new recital is broader in scope.
  - It is useful to add the two examples used in the CP within the text of the recital.
27. ESMA also takes the opportunity to confirm that the addition of the recital is important to ensure that firms have in place appropriate arrangements to ensure that the inclusion of

ESG considerations in the advisory process does not lead to mis-selling practices or misrepresentations and does not damage the interest of the client (for example as an excuse to sell own-products or more costly ones, or to generate unnecessary churning of clients' portfolios, or by firms misrepresenting products or strategies as fulfilling ESG preferences where they do not). Furthermore, as set out in the Consultation Paper, considering the relevance of these conflicts of interest and the new proposed recital, firms would be expected to include a clear reference in their conflict of interests policy on how they are identified and managed.

#### *Other changes*

28. In its Consultation Paper, ESMA asked whether – on the topic of 'organisational requirements' – other amendments should be made to the MiFID II Delegated Regulation in order to incorporate sustainability risks and factors.
29. Almost all respondents answered that no further changes are needed in this area. However, one comment was raised on the fact that the planned updates to the MiFID II Delegated Regulation are an opportunity for ESMA and the Commission to review the provisions of Article 3 on the conditions applicable to the provision of information. It was noted that, given the increased digitisation of relations between firms and their clients, it would be appropriate to review Article 3 in order not to make the use of paper the default option for the provision of information to clients.
30. **ESMA response:** ESMA has carefully considered this comment, but believes that further evidence would be needed, in terms of impact on investor protection, before such a relevant change is made to the legislative text. While ESMA does not rule out suggesting such a change in the future, it considers it premature to include such an amendment within this advice to the Commission.

#### **Technical advice**

*Article 21(1) of the MiFID II Delegated Regulation to be amended as follows*

Investment firms shall comply with the following organisational requirements:

[...]

Where ESG considerations are relevant for the provision of investment services to clients, firms should take them into account when complying with the above requirements.

When complying with the requirements set out in this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.



*Article 23 of the MiFID II Delegated Regulation to be amended as follows*

Investment firms shall take the following actions relating to risk management:

(a) establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall take into account sustainability risk.

[...]

*New recital 59 (bis) of the MiFID II Delegated Regulation to be added*

When identifying the types of conflicts of interest whose existence may damage the interests of a client, investment firms should include those that may stem from the distribution of sustainable investments.

Firms should have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process and portfolio management does not lead to mis-selling practices, including as an excuse to sell own-products or more costly ones, or to generate churning of clients' portfolios, or to misrepresent products or strategies as fulfilling ESG preferences where they do not.

*New recital of the MiFID II Delegated Regulation to be added*

In order for investment firms to comply with their risk management obligations to take into account sustainability risk within their risk management policies and procedures, the investment firms' compliance function, internal audit function, management body and senior management should also consider aspects related to sustainability risk in their respective duties.



### 3 Product governance

#### Background/Mandate

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

The conditions to identify a target market in Commission Delegated Directive 2017/593 adopted under Articles 16(12) and 24(13) of MiFID II and Commission Delegated Regulation 2017/2358 adopted under Article 25(2) of IDD do not explicitly establish the details of the integration of sustainability factors by investment firms manufacturing financial instruments and their distributors and insurance undertakings, intermediaries manufacturing insurance products for sale to customers and insurance distributors referred to in Article 2 of Commission Delegated Regulation 2017/2358 respectively.

In order to ensure that products and, where relevant, the related services are offered in the interest of clients and that sustainability factors are taken into account in the target market assessment, EIOPA and ESMA should analyse the relevant changes to Commission Delegated Regulation 2017/2358, in particular Articles 5 to 11, and Commission Delegated Directive 2017/593, in particular Articles 9(9), 9(11), 10(2) and 10(5).

This approach should duly consider the existing ESMA Guidelines on MiFID II product governance requirements that already provide a good indication on how sustainability factors should be taken into account when identifying the target market. ESMA should ensure that changes to the definition of the target market do not lead to miss-selling practices, e.g. by clearly identifying investment objectives and ESG constraints. In addition, the possibility to identify a target market for clients without ESG preferences should be maintained. When establishing a requirement to consider sustainability factors under the client's objectives and needs, EIOPA and ESMA should also take existing practices for the identification of the target market into account.

The technical advices should be consistent with each other, while recognizing, where relevant, the difference in terminology used by IDD and MiFID II. The technical advices should list in mapping the provisions of delegated acts that should be amended.

#### **Analysis following the public consultation**

1. Many respondents provided ESMA with information on the market standards and labels they use when categorising sustainable investments. From the responses it emerges that there are a multitude of national market standards and labels that are developed for domestic markets.
2. Respondents underlined the challenges of proposing a fully harmonized approach to sustainability risks and factors in MiFID II before a common EU taxonomy is in place, and expressed support for the 'high-level approach' proposed by ESMA in the Consultation Paper. In particular, on the topic of what basis to use for the product categorisation, before a common EU taxonomy is in place, diverging comments were raised:

- Various respondents, including the consumer associations who replied to the consultation, noted that the existing labels are difficult to compare between each other and therefore are difficult to use, in a meaningful way, in a cross-border scenario. These respondents stated that the very large number of divergent standards and labels which exists today on the EU market contributes to the problem of 'green washing'. These respondents stated that ESMA should recognise in its advice to the European Commission that this market does lack uniformity and comparability, and therefore a policy stance relying on the existing standards and labels would not provide a firm footing for future work.
  - On the other hand, other respondents questioned the proposal that firms should be expected to rely on the preparatory works of the Commission, when setting out which ESG preferences a product fulfils, as the rules have not yet been adopted by the co-legislators and could still be subject to change. These respondents suggested instead that as long as there is no mandatory EU harmonised framework/taxonomy constructed, regulators should be hesitant to interfere with market initiatives.
3. **ESMA response:** ESMA acknowledges all 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 FR 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.
  4. With regard to the draft technical advice, as mentioned above, respondents were overall supportive of the approach suggested and noted that – at this stage – it is preferable over detailed requirements. Respondents highlighted the link between the level of detail of the rules and the administrative burden. These respondents noted that a principle-based approach will facilitate the implementation of the requirements and therefore the development of sustainable products. Lastly, the suggested approach will avoid giving the impression that the identification of ESG preferences in the target market should be considered more relevant than clients' investment objectives and other characteristics.
  5. Several respondents highlighted that further guidance could rather be provided by way of questions and answers or guidelines at a later stage, if necessary.
  6. While respondents generally supported the considerations made by ESMA in the analysis section of this chapter of the CP, some respondents however disagreed with the content of paragraph 9, which stated that *"manufacturers and distributors should specify with a meaningful level of granularity which ESG preferences the investment product fulfils. For example, it would not be sufficient to specify that the investment product has, as a target market, clients who are interested in environmentally sustainable, social and good governance investments. Firms should instead specify more precisely which ESG preferences it fulfils"*. These respondents stated that the proposed approach would make the suitability assessment incredibly complex and would not reflect the approach currently

used by the majority of sustainable products. Furthermore, respondents stated that this suggested approach would have a significant impact on the current version of the pan-European template for the target market developed by market participants.

7. **ESMA response:** ESMA acknowledges these comments but believes that the principle-based approach followed in the draft technical advice does not impose a specific approach to firms. ESMA had therefore decided to confirm its technical advice to the Commission. However, ESMA understands the importance of clarifying this issue and aims at providing further guidance when finalising the update of the ESMA guidelines on product governance.
8. Some respondents were of the view that the approach chosen in the draft technical advice to identify ESG preferences for the target market (where relevant) would leave too much flexibility for market participants. Those respondents regard the respective language as a very general and non-specific reference to ESG and argue that such a wording could lead to diverging interpretations and unlevel playing fields. In consequence, these respondents request ESMA to refrain from including a general reference to ESG preferences in Art 9 and 10 of the delegated directive or at least to make the reference more specific, e.g. by deleting “where relevant”.
9. **ESMA response:** In light of the current state of the Sustainability Initiative of the Commission, ESMA has carefully evaluated how much flexibility should be given to market participants at the current stage. The potential negative consequences mentioned by the respondents were weighted against the possible benefits of a more flexible approach, namely allowing market practices to evolve dynamically and not putting innovation at risk. ESMA would like to remind readers that the amendments to the MiFID delegated acts are currently just a first step of a more extensive project. It is to be expected that the requirements for and regulation of sustainability will continuously take more shape as the Commission’s initiative evolves. In light of this, ESMA proposes a regulatory approach which is meant as a starting point and allows market participants to accommodate themselves to ESG-requirements in the context of Product Governance. ESMA will of course accompany and monitor the developments in the area of sustainable finance and propose regulatory adjustments proportionate to the progress made in the market.
10. Some respondents oppose the inclusion of ESG preferences into the target market assessment for distributors. They argue that only the manufacturer can realistically and reliably define whether a product has ESG characteristics or not. They are of the view that it is impossible to verify the ESG profile of a product as defined by a manufacturer due to a lack of available ESG-data on the issuer’s activities. This information shortage is deemed even more critical, where a manufacturer is not subject to MiFID II and therefore not obliged to assess a target market. The distributor has then to assess a target market “as a substitute” – a task which is regarded even more difficult by the respondents given the aforementioned information gaps. In consequence these respondents request ESMA to amend the delegated directive by clarifying that distributors may rely on the ESG target market classification by manufacturers or to remove the reference to the ESG preferences in Article 10 of the MiFID II Delegated Directive.

11. **ESMA response:** ESMA notes that as an important lesson learned from the financial crisis the product governance regime of MiFID II aims at strengthening the responsibility for products not only for manufactures but also for distributors. Manufacturers are naturally at the heart of information and can therefore determine best what the sustainability profile of a product looks like. However, the legislator expects distributors to conduct their own target market assessment according to Article 10(2) of the MiFID II Delegated Directive: In doing so, the distributor scrutinizes the manufacturers target market and eventually refines it according to own data or the specific needs of his client base. ESMA is of the view that in line with this requirement, distributors should not recommend or market products for which they are unable to at least check the plausibility of certain product features – especially if they are used for marketing purposes. Usually, the clients to whom such products are targeted have even less information available to verify whether a product fulfils ESG preferences or not.
  
12. Finally, ESMA notes that on 4 January 2019, the Commission published the updated MiFID rules on how investment firms and insurance distributors should take sustainability issues into account when providing advice to their clients.<sup>12</sup> Within the accompanying explanatory memorandum, the Commission included some modifications to the originally consulted text in order to allow for the necessary differentiation between investment objectives on the one hand and ESG preferences on the other hand. The Commission stated that this differentiation is important in order to avoid mis-selling, which may happen should an ESG consideration take precedence over a client's personal investment objective. In light of this ESMA has updated its technical advice in order to use an approach and wording consistent with that used by the Commission.

### Technical advice

*Article 9(9) of the MiFID II Delegated Directive to be amended as follows*

Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, and ESG preferences (where relevant), the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.

*Article 9(11) of the MiFID II Delegated Directive to be amended as follows*

Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:

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<sup>12</sup> [http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018\\_en.pdf](http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf)

- a) the financial instrument's risk/reward profile is consistent with the target market; and
- b) the financial instrument's ESG characteristics (where relevant) are consistent with the target market; and
- c) financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable.

*Article 9(14) of the MiFID II Delegated Directive to be amended as follows*

Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives, and ESG preferences (where relevant), of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible.

*Article 10(2) of the MiFID II Delegated Directive to be amended as follows*

Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, and ESG preferences (where relevant), of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, firms shall identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible.

*Article 10(5) of the MiFID II Delegated Directive to be amended*

Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives, and ESG preferences (where relevant), of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.

## 4 Annexes

### 4.1 Annex I – Opinion of the Securities and Markets Stakeholder Group

1. ESMA also received the advice of the Securities and Markets Stakeholder Group's (SMSG).<sup>13</sup> The SMSG's stated that it “*supports the work undertaken by ESMA*” and reiterated the comments made in its advice on Sustainable Finance of September 2018<sup>14</sup> and which are recalled in the ESMA CPs provided a series of comments.
2. Furthermore, the SMSG provided the following overarching comments<sup>15</sup>:
  - *“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.*
  - *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.*
  - *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.*

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<sup>13</sup> The SMSG response has been published on the ESMA website (Ref: ESMA22-106-1683).

<sup>14</sup> Ref: ESMA22-106-1301.

<sup>15</sup> See ESMA22-106-1683 for further details.



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

*c) Proportionality.”*

3. These comments, together with the detailed answers provided to the questions in the CP are addressed in the relevant sections of this FR.
4. As noted in Chapter 1 of this FR, all input received on the suggested amendments to the ESMA guidelines on MiFID II product governance requirements<sup>16</sup> and the ESMA guidelines on certain aspects of the MiFID II suitability requirements<sup>17</sup> will be addressed by ESMA at a later stage, within the FR on the updated guidelines.

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<sup>16</sup> Ref: ESMA35-43-620.

<sup>17</sup> Ref: ESMA35-43-869.



## 4.2 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 in end-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 on potential amendments to, or introduction of, delegated acts under Directive 2014/65/EU with regard to the integration of sustainability risks and sustainability factors in firms' internal processes and procedures.
3. It is worth recalling that the CP that ESMA issued on December 2018 presented also changes with regard to ESMA guidelines on MiFID II product governance requirements and to ESMA guidelines on certain aspects of MiFID II suitability requirements. Therefore, the preliminary CBA that ESMA published together with the CP also took into consideration the costs and benefits that were related to the proposed changes to the aforementioned ESMA guidelines.
4. Since this FR is limited to the topics included in the Technical Advice to the Commission (while the final changes to the ESMA guidelines will be published at a later stage), the CBA has been 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 changes on organisational requirements and on product governance requirements. In particular, and in accordance with the Commission's mandate, ESMA proposes changes in the following areas of the MiFID II framework:
5. Organisational requirements, with particular reference to:
  - General organisational requirements (Article 21(1) of MiFID II Delegated Regulation);<sup>18</sup>
  - Risk management (Article 23 of MiFID II Delegated Regulation);

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<sup>18</sup> Commission Delegated Regulation (EU) 2017/565.



- Conflicts of interest (recital of MiFID II Delegated Regulation).
6. Product governance, with particular reference to:
- Manufacturers' obligations on the definition and review of the target market (Articles 9(9), 9(11) and 9(14) of MiFID II Delegated Directive<sup>19</sup>);
  - Distributors' obligations on the definition and review of the target market (Articles 10(2) and 10(5) of MiFID II Delegated Directive).
7. The policy drafting approach adopted by ESMA for the identification of changes to MiFID II delegated acts is consistent with the one adopted by the Commission when designing the CP on changes to (*inter alia*) MiFID II delegated regulation. In particular, references to: ESG considerations<sup>20</sup> or ESG preferences have been added to relevant MiFID II delegated provisions. Such approach received broad support from respondents to the CP.

#### *The impact of the proposed changes*

8. 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 on May 2018, this Technical Advice suggests changes to MiFID II implementation acts to accomplish the mandate received by the Commission on July 2018 aiming at integrating sustainability risks (i.e. environmental, social and governance risks) in the investment decision or advisory processes as part of duties towards investors and/or clients. In particular, it was observed that there is the need to sufficiently address explicit ESG preferences that certain investors might have in order to consider the personal values of such investors in the advisory process and to reflect them in the investment product selection.
9. As stated in the CP, only a qualitative cost-benefit analysis can be performed in relation to the changes identified in this Technical Advice. Respondents to the CP provided some additional 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. However, the data presented were too limited and incomplete to be considered fully representative of the market.
10. As a preliminary remark, ESMA notes that the absence of a common methodology to understand what constitutes a sustainable economic activity, for investment purposes, might have an impact on the comparability among financial instruments. This might imply costs for manufacturers and distributors (while assessing relevant products in accordance with different standards or metrics or when classifying product for the purposes of suitability requirements) and reduce possibilities for investors to effectively compare the standards

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<sup>19</sup> Commission Delegated Directive (EU) 2017/593.

<sup>20</sup> According to the Commission's proposal to amend MiFID II delegated regulation, "ESG considerations means a consideration related to environmentally sustainable investments, social investment or good governance investments" (proposed new paragraph 8 of Article 2 of MiFID II delegated regulation).

of ESG-related disclosures across different companies or investments. Until public or private sectors are able to identify common standards for the classification or the labelling of relevant financial products, this might have an impact on the demand for sustainable investments.

11. The risk of confusing (or distorting) markets should also be carefully considered in this context. One of the essential functions of financial markets is to price risk in order to support informed, efficient capital-allocation decisions. A precise and well-timed disclosure of financial results is fundamental to this purpose, but at the same time it is also important that robust governance and risk management arrangements are in place. A number of respondents to the CP and the SMSG underlined that firms may incur new costs once the EU-wide taxonomy is in force.

### *Benefits*

12. The main positive effect of the proposed changes should consist in an improved and more effective compatibility between investment products and investor preferences and characteristics, which should lead to an increased quality of the services and products offered and sold to investors. The proposed changes will provide clarity on the fact that existing MiFID II duties will require firms to assess ESG factors and to take them into account when serving their clients. This will improve the quality of the services provided by ensuring:
  - a more adequate risk management by relevant entities enhancing the risk-adjusted performance of their products and services benefitting end-investors, particularly over the long term;
  - a coherent approach across sectors and Member States with regard to the integration of ESG factors by relevant entities covering, among others, the areas of corporate governance and risk management.
13. On the other side, reputational benefits from increased disclosure and integration of ESG factors in firms' processes might attract new investors and increase trust in the financial system. Evidence mentioned in the Impact Assessment presented by the Commission suggests that the markets will reward companies that come up with innovative approaches to address ESG factors.
14. Some respondents provided comments on the benefits of the changes suggested by ESMA. Two European associations of investors and unions underlined that the measures aiming to promote the capital shift towards sustainable investments would greatly benefit society as a whole, and that compliance costs expected to be borne by investment firms would be offset by benefits to society and lead to an improvement in net social welfare. A European association of private equity and venture capital linked the benefits of incorporating sustainability risks and factors in MiFID II to a strengthened risk management.



## *Costs*

15. The costs for firms of integrating ESG factors in their internal processes are expected to remain relatively limited. Relevant entities that have not already integrated ESG factors within their processes will need to invest (financial) resources to obtain ESG expertise, data and tools. As also explained in the Impact Assessment provided by the Commission<sup>21</sup>, the feedback received from stakeholders during targeted interviews suggests that these costs should be limited because firms are expected to rely on their existing tools/methodologies.
16. In particular, the need for firms to hire new staff did not emerge as a substantive issue. It is rather a question of investing more systematically in ESG expertise (e.g. employee and board-member training), data and tools. Depending on the current level of ESG integration at firm level, 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 ESG.
17. 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 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 (e.g. the review or update of the arrangements for the identification of the target market) b) direct initial and ongoing IT costs to update current structures and programmes; c) direct organisational and HR costs linked to the qualification of firm staff (in particular compliance function staff and staff devoted to the definition of the target market) or training for board members; d) (possible, depending on current arrangements of relevant firms) direct and on-going costs for buying ESG-related data from third-party vendors; e) initial and on-going costs for reviewing and updating existing risk-management and compliance arrangements.
18. 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 on ESG.

## *Conclusion*

19. Specifying the consideration of ESG factors in, organisational requirements and risk management serves the purpose of avoiding different approaches across firms and Member States in the implementation of the current duties towards clients. It is therefore possible to conclude that the approach followed in this Technical Advice ESMA will increase consumer protection and ensure a level-playing field among the financial market participants.

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<sup>21</sup> See Commission Staff Working Document, Impact Assessment (SWD(2018) 264 final, page 42).



20. ESMA believes that the approach used to indicate changes to the Commission is able to strike a good balance between the need for harmonisation and for flexibility, while achieving the policy objectives of the Commission's mandate and providing clarity on ESG factors' integration and investor protection. ESMA believes that the suggested changes are proportionate in terms of costs for relevant entities, as they appear to require limited investment in ESG expertise, data and tools. The changes will achieve the intended objective of fulfilling the Commission's mandate without imposing unnecessary burden on the relevant entities.
  
21. Therefore, the benefits of such approach are expected to be significantly higher than the potential costs, due to the adoption of harmonised criteria that would ensure more clarity and a coherent approach across the EU with regard to the integration of ESG factors by the relevant entities. This is expected to result in more reliable and comparable ESG information for end-investors.