

MEMO# 31756

May 13, 2019

Summary of ESMA's Final Report to the EU Commission on Proposed ESG-Related Amendments to the UCITS and AIFMD Frameworks

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May 13, 2019 TO: ICI Global Members

Global ESG Task Force

ICI Global Regulated Funds Committee SUBJECTS: International/Global
Investment Advisers

MiFID, EMIR, AIFMD, UCITS V RE: Summary of ESMA's Final Report to the EU Commission on
Proposed ESG-Related Amendments to the UCITS and AIFMD Frameworks

The European and Securities Markets Authority (ESMA) recently issued a final report with technical advice to the European Commission on proposed amendments to delegated acts under the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD).[\[1\]](#) These amendments concern the integration of sustainability risks and factors in the internal processes and procedures of UCITS management companies and alternative investment fund managers (AIFMs).

This is in response to the Commission's July 2018 request for ESMA and EIOPA to prepare technical advice on potential amendments to delegated acts under the UCITS, AIFMD, MiFID II, Solvency II, and IDD frameworks, with the goal of explicitly requiring financial market participants to integrate ESG risks in their decision-making or advisory processes as part of their duties to investors and/or clients.[\[2\]](#) ESMA also released a final report with technical advice to the Commission on proposed amendments to delegated acts under MiFID II.[\[3\]](#) EIOPA separately issued technical advice on the integration of sustainability risks and factors in delegated acts under Solvency II and IDD.[\[4\]](#)

ESMA's report with respect to the UCITS Directive and AIFMD builds on the draft advice from its December consultation paper[\[5\]](#) and discusses the responses it received,[\[6\]](#) including from ICI Global.[\[7\]](#) A brief summary of the most important aspects of the report is as follows:

- **Adds adverse sustainability impact requirement.** ESMA suggests requiring UCITS management companies and AIFMs with more than 500 employees to take into account "the principal adverse impact of investment decisions on sustainability

factors” in their due diligence processes. This is the most significant change from the draft technical advice and is explained in more detail below in the description of the proposed amendments to the due diligence requirements provision.

- **Maintains principles-based approach.** ESMA reiterates its 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. ESMA agrees with the majority of respondents that a principles-based approach is balanced and consistent with the Commission’s mandate without introducing overly prescriptive requirements at this stage.
- **Rejects amendments to fiduciary duty.** A number of respondents suggested that ESMA should link more clearly the integration of sustainability risks and factors to the fiduciary duties of asset managers. ESMA disagrees and explains its view that its proposed amendments to the due diligence and risk management provisions are the appropriate way to integrate sustainability risks in the UCITS and AIFMD frameworks.

Below is a more detailed summary of ESMA’s final report, beginning with ESMA’s general comments and then describing ESMA’s proposed amendments to delegated acts under the UCITS Directive and AIFMD.

I. General Comments

Overarching Commission goals. The report reiterates the Commission’s “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.”

Definitions. ESMA agrees with respondents on the importance of using clear and consistent terminology across the various pieces of sustainable finance legislation. ESMA refrains from suggesting new definitions in its draft technical advice, however, noting that the Disclosure Regulation now defines a number of terms, including defining “sustainability risks” with a reference to materiality. ESMA therefore 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.

Sequencing of taxonomy. ESMA acknowledges industry concerns about sequencing of the Level 2 legislation and the need to complete the taxonomy initiative as a first step.

Supervisory convergence. ESMA agrees with comments from its Securities and Markets Stakeholder Group (MSG)^[8] on the need for supervisory convergence and notes that its advice does not preclude further supervisory convergence work in this area (e.g., through Q&As and/or guidelines). ESMA also recommends that the Commission include a “review clause.”

Consistency with EIOPA. ESMA confirms that it has closely liaised with EIOPA to ensure consistency across sectors.

Implementation timing. ESMA agrees that firms should be given sufficient time to

implement the new requirements and invites the Commission to align the application date of ESMA's proposed legislative amendments with the application date of the relevant provisions in the Disclosure Regulation.

Proportionality. ESMA emphasizes that its proposed amendments should be applied with the proportionality principle in mind, taking into account the size, nature, scale and complexity of authorised entities' activities.

Cost-benefit analysis. The cost-benefit analysis in Annex II only addresses costs and benefits of requiring asset managers to assess and take into account sustainability risks (*i.e.*, ESG-related risks that could affect the financial performance of an investment) when making investment decisions. There is no mention of the costs and benefits of the new adverse sustainability impact provision in ESMA's proposed amendment to the due diligence requirements.

II. Proposed Amendments to Certain Provisions in Delegated Acts under UCITS Directive and AIFMD

Adverse sustainability impact added to "Due Diligence Requirements."^[9] ESMA's proposed amendments differ significantly from its draft technical advice (see new text underlined below) as follows:

[Member States shall require that management companies/AIFMs shall] take into account sustainability risks and, where applicable, 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/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.

ESMA intends this provision to cross-reference the new Disclosure Regulation's website disclosure requirement (Article 3gamma). This provision will require financial market participants with over 500 employees to publish a statement on due diligence policies with respect to "principal adverse impacts of investment decisions on sustainability factors."^[10] Entities with less than 500 employees will be required to provide this disclosure on a comply or explain basis.^[11]

ESMA appears to interpret this Disclosure Regulation provision as substantively requiring UCITS management companies and AIFMs with 500 or more employees to consider "principal adverse impacts of investment decisions on sustainability factors in the due diligence process." We understand, however, that this Disclosure Regulation provision was added as a political compromise and that the Council expressly intended it to require disclosure only—it was not intended as a substantive requirement.

ESMA makes clear though that it believes "[asset managers'] 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**" (emphasis added). ESMA therefore believes that due diligence processes should be designed "to integrate emerging risks and to identify potential and actual adverse impacts and seek to mitigate them, where possible."

ESMA also emphasizes the need for asset managers' active engagement with portfolio companies both to address material sustainability risks *and* to achieve more sustainable outcomes.

Separate from the question of sustainability impact, ESMA agrees with respondents that due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio. ESMA also highlights that the principle of proportionality is already clearly ingrained in the existing due diligence requirements as well as ESMA's proposed amendments. ESMA believes that more prescriptive legislative provisions at this early stage could raise the risks of regulatory inconsistencies and potentially stifle further innovation in this area.

No changes to "General Organisational Requirements."[\[12\]](#) No changes from ESMA's draft technical advice.

No changes to "Resources."[\[13\]](#) No changes from ESMA's draft technical advice. ESMA's consultation had requested feedback on the explicit designation of a qualified person for the integration of sustainability risks. ESMA concludes that this is not necessary to reach the desired objective of the European Commission. ESMA also finds that "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 a legal requirement for all market participants appears disproportionate at this stage."

No changes to "Senior Management Responsibilities."[\[14\]](#) No changes from ESMA's draft technical advice. ESMA believes its proposed amendments "should be sufficient to ensure that senior management is (collectively) responsible for the integration of sustainability risks."

Examples added to "Conflicts of Interest."[\[15\]](#) ESMA adds some examples to its proposed recitals (see new text underlined below) but does not otherwise change the wording of its proposed amendments.

"When identifying the types of conflicts of interest whose existence may damage the interests of a [UCITS/AIF or its investors], [management companies and self-managed UCITS investment companies/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 [UCITS management company/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."

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 that may damage investors. ESMA believes the use of a recital over an article strikes a balanced approach that avoids giving excessive prominence to conflicts arising in relation to sustainable finance over other sources of conflicts of interest.

No changes to “Risk Management.”^[16] No changes from ESMA’s draft technical advice. ESMA believes that a principles-based approach is preferable, since a more granular approach to the integration of sustainability risks in risk management systems could create regulatory imbalances and give sustainability risks precedence over other types of risk.

ESMA also acknowledges the operational challenges involved with obtaining reliable data on sustainability risks and factors. In response, ESMA highlights that the principle of proportionality is already clearly and sufficiently ingrained in the existing Level 1 and Level 2 risk management requirements.

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endnotes

^[1] ESMA’s technical advice with respect to the UCITS Directive and AIFMD is *available at* <https://www.esma.europa.eu/document/final-report-integrating-sustainability-risks-and-factors-in-ucits-directive-and-aifmd>.

^[2] The Commission’s request for technical advice is *available at* <https://eiopa.europa.eu/Publications/Requests%20for%20advice/20180724-Letter%20to%20EIOPA-ESMA-St.Fin.pdf>.

^[3] ESMA’s technical advice with respect to MiFID II is *available at* <https://www.esma.europa.eu/document/final-report-integrating-sustainability-risks-and-factors-in-mifid-ii>.

^[4] EIOPA’s technical advice is *available at* https://eiopa.europa.eu/Publications/EIOPA-BoS-19-172_Final_Report_Technical_advice_for_the_integration_of_sustainability_risks_and_factors.pdf.

^[5] See ICI Memorandum No. 31526 summarizing ESMA’s consultation with respect to the UCITS Directive and AIFMD, *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo31526>.

^[6] ESMA received 60 responses, *available at* <https://www.esma.europa.eu/press-news/consultations/consultation-integrating-sustainability-risks-and-factors-in-ucits>.

^[7] ICI Global’s response to the consultation is *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo31623>.

^[8] See ESMA’s final report, Annex I.

^[9] These amendments concern the consideration of sustainability risks when selecting and monitoring investments, designing written policies and procedures on due diligence and implementing effective arrangements.

^[10] This provision is similar to the due diligence disclosure requirement in the Non-

Financial Reporting Directive, Art. 19a. See summary of the final Disclosure Regulation in ICI Memorandum No. 31696, *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/memo31696>.

[11] Where financial market participants consider principal adverse impacts of investment decisions on sustainability factors, they must publish on their website a statement on due diligence policies with respect to these impacts. If not considering these impacts, financial market participants must disclose clear reasons for not doing so, and where relevant, whether/when they plan to consider them.

[12] These amendments concern the incorporation of sustainability risks within organisational procedures, systems and controls to ensure that they are properly taken into account in the investment and risk management processes.

[13] These amendments concern the consideration of the required resources and expertise for the integration of sustainability risks.

[14] These amendments clarify that the integration of sustainability risks is part of the responsibilities of senior management.

[15] These amendments concern the consideration of the types of conflicts of interest arising in relation to the integration of sustainability risks and factors.

[16] These amendments concern the explicit inclusion of sustainability risks when establishing, implementing, and maintaining an adequate and documented risk management policy.