INVESTMENT COMPANY INSTITUTE

MEMO# 31623

February 21, 2019

ICI Global Response to ESMA Consultation on ESG Integration under UCITS Directive and AIFMD

[31623]

February 21, 2019 TO: ICI Members
ICI Global Members
Global ESG Task Force
ICI Global Regulated Funds Committee SUBJECTS: International/Global
Investment Advisers
MiFID, EMIR, AIFMD, UCITS V RE: ICI Global Response to ESMA Consultation on ESG Integration under UCITS Directive and AIFMD

We submitted the attached response earlier this week to ESMA's consultation paper on draft technical advice to the European Commission on potential amendments to delegated acts under the UCITS Directive and AIFMD.[1] These potential 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).

ESMA is looking for feedback as it develops its response to the Commission's July request for ESMA and EIOPA to prepare technical advice on potential amendments to delegated acts under the UCITS Directive, AIFMD, MiFID II, Solvency II, and IDD frameworks. The Commission's goal is to explicitly require 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]

We expect ESMA to provide its final technical advice to the Commission by the end of April, and we will keep you posted on further developments. In the meantime, please do not hesitate to reach out with any thoughts or questions.

Below is a high-level overview of the points made in our response:

- **Intro:** We strongly support ESMA's high-level, principles-based, and proportionate approach.
    - We explain why it is critical that any regulation of ESG integration be principles-based, provide flexibility, and not negatively impact the investment process.
    - We share ESMA's concerns about the risks of recommending regulatory actions when it is still unclear what elements will be in the final legislation.

    - We also urge ESMA to focus on consistency between the different initiatives and on understanding how they may interact.
- **Q1, Definition of 'sustainability risk.'** We recommend defining 'sustainability risk' as 'environmental, social, or governance factors that pose a material risk to the value of an investment.'
- **Q2, Organisational requirements.** The UCITS Directive and AIFMD provisions on organisational requirements are not relevant to achieving the Commission's aim of integrating sustainability risk into the investment process and therefore should not be amended.
    - We differentiate between risk to the value of a particular investment (i.e., investment risk) and risk to an asset manager or fund as an organisational entity (i.e., business risk).
    - The Commission's request for technical advice on potential amendments to the UCITS Directive and AIFMD discusses sustainability risk as an *investment risk*, not as a business risk.
    - Material risks to a particular investment (such as sustainability risk) are addressed within the investment process (i.e., due diligence)—not in fund managers' internal control programs that are designed to address firm-level and fund-level business risks.
    - We recommend that ESMA instead focus its technical advice on the due diligence requirements in the UCITS Directive and AIFMD, since these are the provisions that are relevant to the Commission's aim of explicitly requiring ESG integration.
- **Q3, Merit of designating a single person to be responsible for ESG integration**. Mandating a person within the firm to be responsible for integrating sustainability risks would lead to a compliance-heavy, box-ticking approach, which would undermine the focus on integrating material ESG information in the investment process.
- **Q5, Proposed amendments to due diligence requirements**. We recommend adding the following language to clarify that fund managers shall 'take into account material sustainability risks and factors as appropriate to the investment strategy of the portfolio when complying with the requirements set out in paragraphs . . . .'
    - Overall, we strongly support ESMA's high-level, principles-based approach, which recognizes that asset managers take different approaches to ESG integration depending on their particular investment process and the investment strategy that they are implementing.
    - We also provide comments on some of the analysis accompanying ESMA's proposed changes.
    - Given the significant limitations around ESG data, we urge ESMA to consider how the rules can be applied in a proportionate way.
- **Q7, Conflicts of interest**. The conflict of interest requirements in the UCITS Directive and AIFMD are not intended to address security-level investment risks, and we do not anticipate conflicts of interest arising with respect to sustainability risk to a portfolio investment.
    - Without specific examples, however, it is unclear how ESMA anticipates sustainability risk causing a conflict of interest.
    - We would welcome further elaboration on how ESMA is thinking about sustainability risks and conflicts of interest.
- **Q9, Risk management**. We clarify that investment management and risk management are separate functions that serve different purposes.
    - Although fund managers' risk management programs cover overall fund-level

risk (such as liquidity or market risk), they are not intended to address specific investment risks to the value of individual portfolio securities.
  - Sustainability risks often are specific to the company or sector in question and are better addressed on a case-by-case investment basis rather than by an overarching risk management process.

Linda M. French
Assistant Chief Counsel, ICI Global

Attachment

endnotes

[1] *Available at* https://www.esma.europa.eu/sites/default/files/library/esma34-45-569_consultation_paper_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_aifmd.pdf.

[2] *Available at* https://eiopa.europa.eu/Publications/Requests%20for%20advice/20180724-Letter%20to%20EIOPA-ESMA-St.Fin.pdf.