

## COMMENT LETTER

July 6, 2020

# ICI Global Response to European Commission's Draft ESG-Related Amendments to MiFID II (pdf)

1 ICI Global's response to the Commission's draft delegated acts that add a new definition of 'sustainability preferences' to the MiFID II framework ICI Global<sup>1</sup> appreciates the opportunity to provide feedback on the European Commission's draft delegated acts that modify the Markets in Financial Instruments Directive framework around suitability and product governance obligations (MiFID II Draft DAs).<sup>2</sup> For Europe's sustainable finance action plan to succeed, the distribution framework for sustainable financial products must connect seamlessly to other building blocks of EU sustainable finance legislation, including the sustainable finance Disclosure Regulation (SFDR).<sup>3</sup> Although well-intentioned, the MiFID II Draft DAs threaten to undermine EU policymakers' multi-year efforts by proposing a definition of 'sustainability preferences' that effectively eliminates the SFDR's Article 8 category of sustainable financial products. This result runs counter to the work that has been accomplished to date through the EU legislative process. We therefore urge the Commission to revise the definition of 'sustainability preferences' to permit both SFDR Article 8 and Article 9 products to meet investors' 'sustainability preferences.' <sup>4</sup> Allowing both categories of sustainable products to be offered to investors would be consistent with the intent of EU co-legislators in adopting the SFDR and would better meet the EU's objectives of mainstreaming sustainable finance, facilitating the transition to a low carbon economy, and increasing retail investor engagement in the capital markets. 1 ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$31.3 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

2 See COMMISSION DELEGATED REGULATION (EU) .../...of XXX amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, available at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017-565->. See also COMMISSION DELEGATED DIRECTIVE (EU) .../... of XXX amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations, available at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive->

EU-2017-593-. 3 See REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability-related disclosures in the financial services sector, available at <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>. 4 SFDR Article 8 products are those which ‘promote environmental or social characteristics.’ SFDR Article 9 products ‘have an objective of sustainable investments.’ See SFDR, Articles 8 and 9. 2 The proposed definition of ‘sustainability preferences’ in the MiFID II Draft DAs undermines the SFDR by effectively eliminating SFDR Article 8 products. EU co-legislators created two categories of sustainable investment products in the SFDR: Article 8 products that ‘promote environmental or social characteristics’ and Article 9 products that ‘have an objective of sustainable investments.’<sup>5</sup> The MiFID II DAs are intended to reinforce the SFDR and other sustainable finance legislation, ‘integrat[ing] sustainability considerations into the investment, advisory and disclosure processes in a consistent manner across sectors.’<sup>6</sup> The MiFID II DAs require (1) investment firms to ask clients about their ‘sustainability preferences’ during the suitability assessment and then take those preferences into account when selecting investments; and (2) manufacturers and distributors to take clients’ ‘sustainability preferences’ into account in product governance and oversight arrangements (including when conducting a target market assessment). ESMA’s 2019 technical advice to the Commission recommended permitting both SFDR Article 8 and Article 9 financial products to be deemed to meet clients’ ‘sustainability preferences’ and therefore distributed as ESG products.<sup>7</sup> The MiFID II DAs, however, propose a narrower definition of ‘sustainability preferences’ as follows: ‘Sustainability preferences’ means a client’s choice as to whether either of the following should be integrated into his investment strategy: i) a financial instrument with the objective of sustainable investments (as defined in SFDR Article 9); or ii) a financial instrument that promotes environmental or social characteristics (as defined in SFDR Article 8) and that either: a) pursues sustainable investments (as defined in SFDR Article 2(17)); or b) considers principal adverse impacts (per SFDR Article 7). 5 See SFDR, Recital 21 (‘Sustainable products with various degrees of ambition have been developed to date. Therefore, for the purposes of pre-contractual disclosures and disclosures in periodical reports, it is necessary to distinguish between the requirements for financial products which promote environmental or social characteristics and those for financial products which have as an objective a positive impact on the environment and society.’). 6 See MIFID II DAs, *supra* note 2. 7 See ESMA’s Final Report on Integrating Sustainability Risks and Factors in MiFID II, available at <https://www.esma.europa.eu/document/final-report-integrating-sustainability-risks-and-factors-in-mifid-ii>. 3 Under this narrower definition, Article 9 products still qualify as meeting clients’ ‘sustainability preferences,’ thereby qualifying for distribution as ESG products. But the Commission’s proposed definition adds new conditions that Article 8 products must meet, effectively eliminating the Article 8 category of products as established in the SFDR. The first new condition would collapse the distinction between an Article 8 product (that ‘promotes environmental or social characteristics’) and an Article 9 product (that ‘has an objective of sustainable investments’). An Article 8 product that ‘pursues sustainable investments’ is effectively an Article 9 product that ‘has an objective of sustainable investments.’ We also note that the draft regulatory technical standards (RTS) for the SFDR require Article 8 products to disclose that ‘This product does not have as its objective sustainable investment.’<sup>8</sup> This approach is inconsistent with the co-legislators’ creation of distinct Article 8 and Article 9 product categories. The second new condition would require an Article 8 product to consider adverse impacts on sustainability factors. A product that considers adverse impacts is more likely to be an Article 9 product with an objective of sustainable investments, as consideration of adverse impact is probably the most complex element of the analysis of whether an investment is sustainable. This again collapses the SFDR level 1 distinction between the two product categories. 9 In Recital 6, the Commission

argues that Article 8 products (that pursue environmental or social characteristics) do not necessarily guarantee the achievement of a certain level of sustainability and that, to meet a client's sustainability preferences, an Article 8 product should pursue sustainable investment.<sup>8</sup> See draft RTS, Article 16, available at [https://www.esma.europa.eu/sites/default/files/jc\\_2020\\_16\\_-\\_joint\\_consultation\\_paper\\_on\\_esg\\_disclosures.pdf](https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf).<sup>9</sup> We note that this condition also significantly changes the application of SFDR Article 4 in a way that does not respect what was adopted by the co-legislators. To meet this new condition of considering adverse sustainability impacts at the product level, an asset manager also must meet the SFDR's entity-level disclosure requirements. See SFDR Article 7. But the SFDR mandates entity level principal adverse impact disclosure only for financial market participants with more than 500 employees; financial market participants with less than 500 employees have the option to 'comply or explain'. See SFDR Article 4. Requiring this adverse impact disclosure at the product level functions as a backdoor means of requiring it for financial market participants with less than 500 employees that wish to manage products that meet clients' sustainability preferences (and therefore qualify for distribution as ESG products). This approach ignores Article 4's proportionality principle that allows smaller entities to decide whether to comply or explain their entity-level adverse impacts. Forcing smaller entities that wish to offer products that satisfy clients' sustainability preferences to undertake the SFDR's prescribed adverse impact entity-level disclosure would be a significant and costly undertaking. At a time when the EU is making efforts to promote growth of smaller and medium-sized enterprises (SMEs), this new requirement would potentially create insurmountable barriers to entry for SMEs.<sup>4</sup> objectives to some extent.<sup>10</sup> Regardless of the Commission's views of Article 8 products, the co-legislators already determined that there should be two categories of sustainable products—Article 8 and Article 9 products—and recognized legitimate reasons for their differences. Each product category has a specific role in the context of the EU Green Deal, with Article 8 ensuring that products are created and available to accommodate client preferences that are along the ESG spectrum. If Article 8 products cannot satisfy an investor's sustainability preferences and must adopt features that make them Article 9 products, there would be no reason for Article 8 products to be created or offered to investors. In effect, the Commission's definition of 'sustainability preferences' would render superfluous SFDR Article 8's product category and definition. We do not believe the EU co-legislators would have created an Article 8 product category, subject to extensive disclosure requirements under the SFDR, that could not be distributed as meeting investors' 'sustainability preferences.' We urge the Commission not to undermine the SFDR by adopting provisions in the level 2 DAs that effectively eliminate one of the two categories of ESG products. Narrowing the universe of available ESG products conflicts with the EU's objectives. We caution that requiring these two new conditions for Article 8 products will significantly narrow the universe of available ESG products in conflict with the EU's objectives. Most if not all products that would qualify under Article 8 in SFDR would have to be transformed into Article 9 products to meet the proposed new conditions in the DAs. Article 8 products as contemplated in the SFDR therefore would not be offered because they would not be deemed to satisfy an investor's 'sustainability preferences.' Narrowing the universe of available ESG products jeopardizes the EU's objective of mainstreaming sustainable finance. The new, narrower definition of 'sustainability preferences' will constrain the ESG product universe to more niche products. There is currently a small investable universe of investments that meet the SFDR's definition of 'sustainable investments.'<sup>11</sup> Crowding investors into these niche

<sup>10</sup> See MiFID II Draft DAs, Recital 6 ("Whilst financial products that pursue sustainable investment objectives guarantee the attainment of certain level of sustainability, financial products that promote environmental or social characteristics do not necessarily achieve that. That is why the

identification of the client's sustainability preferences should in case of financial products that promote environmental or social characteristics take into account those financial products that at least to some extent pursue sustainable investment objectives . . . ."). 11 SFDR Article 2(17) defines 'sustainable investment' as 'an investment in an economic activity that contributes to an environmental objective, as measured for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or on an investment in an economic activity that contributes to a social objective, in particular, an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such 5 products with a small investable universe runs counter to the Commission's objective of mainstreaming sustainable finance. Narrowing the universe of available ESG products also runs counter to the EU's objective of facilitating the transition to a low carbon economy. Article 8 products are permitted to invest more broadly than Article 9 products, including in industries that are transitioning to sustainability. Although these investments are unlikely to meet the strict definition of a 'sustainable investment', these transition investments are key in moving the economy toward a more sustainable future. For example, asset managers often engage with investee companies on sustainability-related issues in line with the objectives of the fund or client mandate. Investment in transitioning companies is a key element in expanding the investable universe of 'sustainable investments.' This narrow approach also is inconsistent with another key initiative of the Commission—boosting EU capital markets through facilitating a broader range of retail products that appeal to EU citizens. Narrowing the universe of available ESG products will limit at the outset what products EU citizens can access. Asset managers create products to meet investor demand, and the range of investor demand for different types of ESG strategies is broader than merely Article 9 types of products. We therefore urge the Commission to revise the definition of 'sustainability preferences' to permit both SFDR Article 8 and Article 9 products to meet investors' 'sustainability preferences'—an approach that would better align with the EU's objectives of mainstreaming sustainable finance, facilitating the transition to a low carbon economy, and increasing retail investor engagement in the capital markets. investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.'