Frankfurt am Main,
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BVI's response to the Consultation Paper "On integrating sustainability risks and factors in MiFID II" published by ESMA on 19 December 2018 (ESMA35-43-1210)

Encouraging investments in sustainable products is a core element of the broader move towards a more sustainable environment. ESG factors play an increasingly important role in investment decisions. A growing number of institutional investors and asset managers already use methods of selecting investments taking material ESG considerations into account throughout their portfolios.

BVI[1] is therefore supportive and welcomes the pending EU measures on sustainable finance, including incorporation of sustainability into investment advice and product governance requirements. **In particular, we strongly agree with the high-level, principle-based approach proposed by ESMA.** In an ideal world, a common understanding on sustainability would have been developed beforehand. However, given the parallel running initiatives and the rapid market developments regarding sustainable finance, it is of utmost importance that the regulatory requirements remain flexible enough in order to facilitate these developments. We are convinced that principle-based rules are the right approach at the current stage of the ongoing process for the following reasons:

- Investors and advisors need to be educated regarding sustainable finance, and some market players are more advanced than others. Principle-based rules facilitate such education and enable less advanced market participants to get on board. Market participants are allowed to move forward from their different starting points while avoiding a burdensome and extensive implementation.

- Principle-based rules are likely to be compatible with future developments such as the establishment of the Taxonomy and extension of the EU Ecolabel. Detailed requirements, if established at this stage, will most probably deviate from future developments. Double implementation would confuse investors and be detrimental to a positive approach towards sustainability. Rather than requiring investors and market participants to implement detailed requirements which would possibly have to be adjusted due to future developments, ESMA's principle-based approach allows using and refining existing approaches.

- Principle-based rules keep the balance with other MiFID II requirements. A more detailed legislation always gives the impression that this aspect is more important than others. If, for instance, the identification of ESG preferences in the target market were described in more detail than the other elements of the target market, they would likely be considered more relevant.

As a more general observation, we see deviations in the wording of ESMA's consultation paper regarding changes to AIFMD and UCITS Directive and the consultation paper regarding amendments to MiFID II. While the former uses the terms "sustainability risks and factors", the latter uses "ESG

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's more than 100 members manage assets of some 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 22% in the EU Germany represents the largest fund market as well as the second fastest growing market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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considerations” and “environmental, social and governance factors”. We suggest aligning the wording, where possible.

Section 2: Organisational requirements

Q1: *Do you agree with the suggested approach and the changes to the Article 21 of the MiFID II Delegated Regulation on ‘general organisational requirements’? Please state the reasons for your answer.*

We strongly agree with the high-level, principle-based approach proposed by ESMA. In our view, this concept will allow for appropriate consideration of sustainability risks and factors without further interfering with the organisational arrangements already established by MiFID firms. It is also in line with the regulatory approach followed regarding other relevant risks under other EU frameworks, especially UCITS and AIFM Directives. Moreover, given the current regulatory dynamics in the area of sustainable finance, a principle-based approach appears best-placed to accommodate potential implications of pending legislative procedures at EU level. We agree with ESMA that staff involved in the advisory process should have the knowledge and expertise for the assessment of sustainability risks. Lastly, we agree with ESMA that principle-based rules keep the balance with other MiFID II requirements.

Q2: *Do you agree with the suggested approach and the changes to the Article 23 of the MiFID II Delegated Regulation on ‘risk management’? Please state the reasons for your answer.*

We are not sure to what extent ESG factors can indeed be relevant for the risks relating to a MiFID firm’s activity. As far as they are relevant, we agree with ESMA’s approach to take ESG factors into account where relevant for the risks. We generally note that in this regard, ESMA’s wording for UCITS and AIF management companies seems different since ESMA there defines sustainability risk as a separate risk category. In any case, we agree with the general understanding that ESG factors have to be taken into account where they create the risk of fluctuation in the value of positions in the portfolio.

Q3: *Do you agree with the suggested approach and the new recital on ‘conflicts of interest’? Please state the reasons for your answer. What would be specific examples of conflicts of interests that might arise in relation to sustainability considerations?*

While we generally agree that ESG considerations should not lead to mis-selling practices, we are not sure whether the conflict of interest requirements are the right way to address this issue. From a practical point of view, the advisory and product governance process are better placed for this purpose, in particular by addressing the understanding that the product has to be, where relevant, compatible with the client’s needs and objectives and in case of investment advice also suitable.

Consequently, we suggest deleting the first paragraph of the proposed recital and to focus regulatory guidance on the inclusion of ESG considerations in the advisory and portfolio management process.

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***Q4:** Do you think that 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? If yes, which ones? Please state the reasons for your answer.*

No. We generally think that regarding services provided by a MiFID firm, sustainability aspects can be relevant in particular for portfolio management and activities related to marketing of financial instruments. Therefore, the proposed changes to the suitability test and the product governance rules are addressing the consideration of sustainability risks sufficiently.

Section 3: Product governance

***Q5:** Which existing market standards or "labels" are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.*

Generally, labels have the chance to provide a standardised approach which will facilitate the advisory process for both the investor and the advisor. Currently there is no internationally accepted label. In particular for fund managers marketing products throughout the EU, an EU ESG label would be very welcome.

Our members use the following existing labels:
- Siegel Forum Nachhaltige Geldanlagen (German Social Investment Forum), see https://fng-siegel.org/en/
- LuxFlag (Luxembourg), see https://www.luxflag.org/
- Österreichisches Umweltzeichen (Austria), see https://www.umweltzeichen.at/de/produkte/finanzprodukte

The main problem with labels is the general challenge regarding sustainable funds, i.e. how to convey the understanding of sustainability to investors. While labels support comparability and facilitate transparency, it is e.g. still difficult to explain how potential exclusions are applied, and that exclusion criteria can often not be applied to 100 percent. Furthermore, explaining to retail investors the distinction between sustainable products focussing on process by applying international recognised strategies, such as "best in class", and products that aim at a specific impact due to financing specific projects is demanding.

ESMA's idea to categorise ESG preferences according to the Taxonomy proposal (para. 8 on page 14) does not seem very practical:
- First, it is possibly not in line with investors' expectations. For instance, investors usually do not distinguish between climate mitigation and climate adaptation or between waste prevention and a healthy ecosystem. We therefore believe that this approach is too complex and would probably overstrain customers.
- Second, the Taxonomy proposal is still under discussion, meaning that the final delineations are still unclear. An implementation now on that preliminary basis followed by an adjustment later on would further confuse consumers and require the market to adjust recently implemented systems. Both

aspects would not facilitate a positive approach towards sustainability which is vital in order to achieve the urgently needed progress.

- Third, we doubt that the Taxonomy, once completed, will allow specification of ESG preferences. The Taxonomy will only focus on economic activities, and therefore be much more detailed and on a different level than ESG preferences applicable to financial instruments covering solely such activities such as green bonds. For the majority of financial instruments, the Taxonomy alone will not allow retail investors to identify environmentally sustainable investments.

Nevertheless, we support the aim to develop a European ESG Label. This could facilitate the product governance and distribution process. Absent such label, the requirements should not be descriptive or built on ideas of the Taxonomy which is still under construction. For the time being, integrating the different preferences in one factor would be a feasible solution.

Q6: *Do you agree with the suggested approach and the proposed amendments to the MiFID II Delegated Directive Articles on 'product governance'? If not, please explain.*

We strongly agree with the high-level, principle-based approach proposed by ESMA. Absent a common understanding on sustainability, this approach facilitates rapid market developments and allows for compliance in accordance with the state-of-the-art. Conversely, a detailed approach would possibly require a sequence of several significant implementation projects, since the first implementation would likely have to be adapted once the Taxonomy and the Eco or ESG Label are established and a common understanding on sustainability evolves further. In addition, we strongly believe that this approach will allow market participants to move forward from their different starting points, thereby creating a more positive attitude towards sustainable finance than detailed requirements. The latter would be more complex to implement and risk that the task becomes a mere compliance exercise. We see a clear link between the detail of rules, the administrative burden on the one hand and the reception of new rules by the market on the other. Hence, we are convinced that a principle-based approach allows a more positive perception of the initiative which in turn will facilitate sustainable finance. Lastly, a more detailed legislation always gives the impression that a certain aspect is more important than others. If, for instance, the identification of ESG preferences in the target market were described in more detail than the investor's needs, they would likely be considered more relevant. In order to keep the balance with existing requirements, the legal text should not provide more detail. Specific guidance could rather be provided by way of questions and answers or guidelines at a later stage, if necessary.

Furthermore, as rightly pointed out by ESMA, the specific needs like ESG preferences are different to other target market criteria: Products addressing such specific preferences might still be compatible with investors who do not have such preferences. It is therefore important the rules reflect such mechanism – as it is done by ESMA with the term "where relevant" and the recognition that the ESG preferences are not relevant for the assessment of a negative target market.

Q7: *Do you agree with the proposed changes to the ESMA Guidelines on MiFID II product governance requirements and the addition of an additional case study? If not, please explain what changes should be made and why.*

We agree with the proposed changes, in particular the recognition to apply the requirements only where relevant. Based on the proposed changes in ESMA's consultation paper regarding the UCITS and AIFM frameworks, we see a coherent concept for funds: European fund managers will be required to take ESG considerations into account as part of the due diligence for all funds; in addition, there will be specific sustainable funds for which ESG characteristics can be determined.

However, in our point of view, the case study regarding the impact investment fund does not seem very realistic. For instance, an infrastructure debt fund would not very likely have an SRI of 2 and most probably not be open-ended. Further, it is unclear what the "green project" certificate would be based on. Lastly, the fund cannot be a UCITS since unlisted assets are not eligible under the UCITS framework, even though the specific reference to the UCITS KIID implies otherwise. We therefore do not see a merit in this specific case study and suggest it is deleted.

Q8: *Do you think extra guidance is needed on the elements listed in paragraph 15 above? If yes, please provide details.*

While we do not see the need for further guidance, should ESMA decide otherwise, it should be based on the following aspects:

- We agree with ESMA's approach that ESG considerations should not be relevant as a factor in the definition of a negative target market. If clients' objectives do not comprise ESG preferences, a sustainable product could still serve their objectives and needs.
- If the client has ESG preferences but the product does not have ESG characteristics, this could be clarified within the advisory process. ESG preferences will always constitute one aspect of the investors' investment decision. In practice, there will be cases where the investor prefers the product without ESG characteristics since it fits better with his/her other objectives and needs.

Q9: *Please specify any approach you see to identify environmental, social and governance criteria separately from each other or as a single indicator. Please explain how the criteria would interact with each other and how the target market assessment and matching would be performed in such cases.*

ESG characteristics should not be specified separately. While there are some products that specifically address the "environmental" or "social" considerations, the vast majority of products address both even in cases the focus is more on one or the other. The "governance" characteristic is rather perceived as a minimum criterion for any sustainable product and is even relevant on a standalone basis for products that are not specifically considered sustainable. Furthermore, all ESG aspects interact with each other. For instance, a company with poor governance is more likely to not comply with ILO standards or harm the environment than a company with an effective governance system in place. Even in case clients do have a preference for social or environmental aspects, they would also fall into the target market of products addressing both aspects.

Section 4: Suitability

***Q10:** What current market standards or "labels" are you intending to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.*

Please see our answer to question 5. We do believe that a European ESG Label has the potential to facilitate both investors' and advisors' analysis of the product.

***Q11:** Do you agree with the suggested approach and the amendments to paragraph 28 of the suitability guidelines? If not, do you have any suggestions for developing a more detailed approach with regard to (a) the collection of information from clients and (b) the assessment of ESG preferences with the assessment of suitability?*

No, we do not agree with the suggested amendments. In particular, we would like to emphasise again that the classification system is not the right basis for collecting information on clients' preferences (cf. our answer to question 5.) and that we do not believe in the distinction between environmental, social or governance factors. Furthermore, the approaches differ depending on the specific client. For instance, professional clients are more likely to have clear expectations towards the ESG characteristics of a product. ESMA has already stated in its existing guidelines that it considers it good practice for firms to collect information on the client's preferences on environmental, social and governance factors. Therefore, firms are currently developing the best approach to collect this information based on clients' approaches towards sustainability. We doubt that ESMA's proposed amendments are likely to be in line with the clients' approaches towards sustainability. We would therefore ask ESMA to refrain from too detailed mandatory wording in order to allow for firms to develop concepts addressing clients' approaches. We would therefore suggest the following wording for paragraph 28:

> "When collecting information about their clients' ESG preferences, ~~**firms should ask questions in relation to environmental, social and governance factors. The**~~**the** information collected on clients' ESG preferences should be granular enough to allow the firm to assess the suitability of the investment. ~~**and should be consistent with the EU's classification system of ESG investment products, once developed. While this classification system is under development, investment**~~**Investment** firms should clearly specify what they consider to be ESG preferences or considerations, while taking into account current market standards."

***Q12:** Please specify any approach you see to assess environmental, social and governance criteria separately from each other or as single preferences. Please explain how the criteria would interact with each other and how the suitability assessment would be performed in such cases.*

As stated before (cf. our reply to question 9), we do not think that environmental, social and governance criteria should be assessed separately but as a single preference since they interact and funds usually take into account all criteria even if for some products there is an emphasis on one criterion (e.g. climate funds). In addition, we would like to point out that ESMA's second example in paragraph 12 (the more advanced approach) is very unlikely to become a standard within a reasonable period. In practice, measuring or even calculating ESG profiles in a reliable manner, is very difficult and might remain so for quite some time. Therefore, we would consider ESMA's first example already as an advanced approach. In addition, investment advice rendered can just refer to a specific financial instrument and does not necessarily comprise a portfolio approach.

We do agree with the assessment in paragraph 11 and 14. We agree with ESMA that the range of suitable products should be identified before clients' ESG preferences are addressed. Furthermore, we agree that ESG products can be equally suitable for clients with no ESG preferences as products without such characteristics or the other way around.

Q13: *Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?*

Yes, we agree with this approach. It is of high relevance that ESMA suggests clarifying that the ESG considerations only apply where relevant. We appreciate ESMA's statement in paragraph 17 regarding the timeframe in which ESG preferences should be collected from existing clients. As regards implementation of MiFID II, most clients did not understand the process firms had to carry out. Rather they felt interrogated and bothered. Asking them again in a short time frame to fill out updated questionnaires would facilitate neither a positive approach towards sustainable finance nor towards investments in financial instruments generally. Hence, we fully support ESMA's flexible approach indicated in paragraph 17.

Annex II: Cost-Benefit Analysis

Q14: *What level of resources (financial and other) would be required to implement and comply with the proposed changes (risk-management arrangements, market researches and analyses, organisational costs, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.*

Below information is only an example of one of our members' assessment

Information requested	**Firm response**
Firm size (annual turnover in euro)	
Number of employees	
Firm complexity (low/medium/high)	high
Expected costs from market research related to ESG factors (in euro)	950,000 Euro p. a.
Expected IT costs related to ESG factors, initial and on-going (in euro)	Initial: 450,000 Euro
	On-going:50,000 Euro
Expected training costs related to ESG factors (in euro)	Initial: 750,000 Euro
	On-going: 100,000 Euro
Other expected organisational costs related to ESG factors (in euro) – *please describe*	Initial: 750,000 Euro
	On-going: 80,000 Euro