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ICI Global response to ESMA consultation on integrating sustainability risk and factors in the UCITS Directive and AIFMD

ICI Global[1] welcomes ESMA's work to provide the European Commission with technical advice to assist the Commission in implementing its action plan to finance sustainable growth. We support the Commission's efforts to foster a regulatory framework that encourages the financial system to focus appropriately on the longer-term impact of material environmental, social, and governance (ESG) factors.

We strongly support ESMA's high-level, principles-based and proportionate approach. This approach appropriately recognizes that the integration of sustainability risks within the UCITS Directive and AIFM Directive frameworks should be treated similarly to the manner in which these frameworks require assessments of other material risks in the investment process.

Fund managers consider material ESG risks in the investment process as they do other material investment risks, such as interest rate risk or credit risk. Integrating ESG information into the investment process to help enhance risk-adjusted returns is commonly referred to as 'ESG integration.' Each fund manager's investment process, including ESG integration, is individualized and proprietary. Because of the unique nature of each fund manager's investment process, there is no uniform way to integrate material ESG information into the investment process.

Moreover, the ability of fund managers to understand and analyze different ESG factors continues to improve and develop at a rapid pace. At the same time, the evolution of ESG analysis poses certain challenges for fund managers. Managers can obtain ESG-related research and data from various service providers, representing a whole spectrum of methodologies, and there is a lack of consensus around how to quantify many ESG risks. Fund managers are navigating these issues in various ways, including conducting their own proprietary research and engaging with companies to gain a deeper

[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$27.7 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.

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understanding of which ESG factors may pose a material risk to the value of a particular portfolio security.

Within this evolving landscape, fund managers view ESG integration as a means of identifying investment opportunities, managing investment risk, and enhancing risk-adjusted returns for their investors. As a result, fund managers have generally embraced ESG integration even in the absence of a regulatory mandate. For this reason, it is critical that any regulation of ESG integration be principles-based, provide flexibility, and not negatively impact the investment process. An inflexible, prescriptive approach could disrupt the investment process, turning ESG integration into an artificial compliance checklist, or impose a separate overlay onto the investment process that would defeat the purpose of the Commission's objective of fostering true ESG integration.

We also welcome ESMA's focus on proportionality, taking into account the size, nature, scale, and complexity of an asset manager's activities and relevant investment strategies pursued. For example, a fund manager may integrate ESG information differently for a fixed income investment strategy as compared to an emerging markets equity strategy, and ESMA's approach must allow for these differences.

With respect to timing and process, there are many challenges associated with responding to the Commission's request for technical advice, especially considering that the co-legislators have not yet finalized several relevant legislative files on sustainable finance. 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. Ongoing efforts that apply to insurance companies and investment firms also will affect asset managers (whether directly or indirectly). It will be important to avoid conflicting definitions or requirements, and we recognize it may prove difficult to maintain consistency among the various pieces of the Commission's sustainable finance action plan without the foundation of an established EU taxonomy.

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Q1: How do you understand or how would you define the notion of 'sustainability risks' for the purposes of the delegated acts adopted under the UCITS Directive and AIFMD?

We recommend defining 'sustainability risk' as 'environmental, social, or governance factors that pose a material risk to the value of an investment.'

We support a definition of 'sustainability risk' that focuses on the financial risk to a fund's investment returns—not on the impact of those investments on the broader environment and society.[2] ESG integration is about maximizing value for fund investors within the given risk/return parameters of the investment strategy's objectives. As part of the investment process, a fund's investment team analyzes and takes into account the financial risk that material ESG factors may pose to the value of a fund's investments. The risks (and factors relevant to the risk) will depend on the type of investment.

ESMA's working definition of 'sustainability risk' references the risk of 'fluctuation in the value' of positions in the fund's portfolio due to ESG factors. This definition focuses on risk of volatility or fluctuation. Instead, we recommend focusing the definition on risk to the long-term value of an investment, appropriately accounting for investment strategies that may be more short-term.

The definition of sustainability risk also should incorporate the concept of materiality. Portfolio managers do not (and should not) treat all risks equally or treat them as being meaningful in all circumstances. In determining whether ESG information is material to a particular investment, a portfolio manager analyzes the relevance of the information to the industry in which it operates and the potential impact on the financial health of the investment in the context of a fund's investment

[2] We note that one type of ESG investing, called 'impact investing,' specifically focuses on investing with the intention to generate and measure social and environmental benefits alongside a financial return. Impact investing generally aims to strike a balance between an economic and social return—with a varying emphasis, depending on the specific impact project/fund.

A fund manager therefore would take a broader view of the impact of an investment for an impact investing fund with a strategy that has a stated sustainability impact. In this case, the fund's disclosure would describe the fund's impact investing approach, including to what degree the fund prioritizes impact over investment returns. Disclosures for impact investing funds are different from certain cases where the fund manager considers the impact of the investment as part of their investment process (*e.g.,* use of proceeds of Green Bonds) to determine if a security fits within a sustainable investment theme.

strategy. The fact that a particular risk is conventionally classified as an ESG or sustainability risk will not be conclusive as to whether it is financially material or not. A particular ESG risk may be material to one portfolio investment but not material to another.[3]

The materiality framework also provides for flexibility as issues and industries evolve. As ESMA and the Commission are well aware, understanding of ESG issues and access to ESG-related data have shifted significantly over the past ten years and will continue to develop over time. This shift in available data is bringing new issues to the attention of investors, fund managers, and the companies in which funds invest.

In emphasizing the need for consistency across various initiatives, we highlight that the MiFID II consultation uses the terms 'ESG considerations' and 'ESG factors.' We also note that ESMA's proposed amendments refer not only to 'sustainability risks' but also to 'sustainability factors,' without defining the differences between these two concepts.

Q2: Do you agree with the proposed amendments relating to organisational requirements included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

As ESMA develops its technical advice to the Commission, it is essential to differentiate between risk to the value of a particular investment and risk to an asset manager or fund as an organisational entity. Throughout the rest of our consultation response, we refer to these two categories of risk as 'investment risk' and '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. The Commission's letter to ESMA asks for advice on how to explicitly require asset managers to integrate sustainability

[3] For example, a joint World Bank/GPIF report noted that water stress is likely to be a material factor for certain sectors, such as extractives, food and beverage, and agricultural companies. *See* Inderst, G. and Stewart, F., *Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment*, World Bank Group publication, April 2018, at p. 11, *available at* http://documents.worldbank.org/curated/en/913961524150628959/pdf/125442-REPL-PUBLIC-Incorporating-ESG-Factors-into-Fixed-Income-Investment-Final-April26-LowRes.pdf.

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risks into their investment processes, to address material risk that ESG factors pose to the value funds' portfolio investments and therefore to long-term investor returns.[4]

The Commission's request for technical advice lists various provisions in the UCITS Directive and AIFMD and invites ESMA to provide technical advice on how to amend these provisions, *where relevant*, to achieve the Commission's aim. Many of the listed provisions do not address investment risk and therefore are not relevant to achieving the Commission's aim.

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. It is important to distinguish between the function of the investment team (which includes its own investment risk infrastructure) that is responsible for ESG integration and assessment of the risk each investment presents, and the independent functions of compliance and audit that ensure that the investment processes accurately reflect the funds' investment strategies and other ESG disclosures that fund managers provide to investors.

We therefore urge ESMA to recommend amending only those provisions that are relevant to achieving the Commission's stated aim. Specifically, we recommend that ESMA focus its technical advice on the due diligence requirements in the UCITS Directive and AIFMD. These are the provisions that are relevant to the Commission's aim of integrating sustainability risk into the investment process.

Organisational requirements. The organisational requirements in the UCITS Directive and AIFMD are not intended to address specific investment risks to the value of individual portfolio securities. ESMA's amendments to UCITS Directive Article 4 and AIFMD Article 57, however, would require both compliance and internal audit functions to incorporate sustainability risk assessment in their control programs.

Asset managers' compliance or internal audit control programs do not cover management of security-level investment risks. Rather they address business risks such as anti-money laundering, fraud, business

[4] European Commission letter to ESMA and EIOPA, dated 7 July 2018, *available at* https://eiopa.europa.eu/Publications/Requests%20for%20advice/20180724-Letter%20to%20EIOPA-ESMA-St.Fin.pdf.

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continuity, valuation/pricing procedures, client information security, trading errors, insider trading, and due diligence processes for the organisation as a whole. As noted above, the incorporation of ESG integration into the investment process is the responsibility of the portfolio management teams. Personnel such as the Chief Investment Officer provide oversight to ensure funds are managed in accordance with their strategy and risk profile as disclosed to investors. Compliance and audit personnel ensure that the investment teams are managing their portfolios in accordance with their ESG-related disclosures and the firm's ESG policy, but they are not intended to second-guess the research and analysis of the portfolio managers.

As discussed in our response to Q5, investment risks are addressed in due diligence, as part of an asset manager's investment process, not in an asset manager's control programs. The UCITS Directive and AIFMD provisions on organisational requirements therefore are not relevant to achieving the Commission's aim and should not be amended.

Senior management responsibilities. We have similar feedback on ESMA's proposed amendments to the UCITS Directive Article 9 and AIFMD Article 60. These amendments aim to clarify that the integration of sustainability risk is part of the responsibilities of an asset manager's senior management, by requiring senior management to institute internal control mechanisms and systematic processes that ensure appropriate consideration of ESG risks and factors.

These UCITS Directive and AIFMD provisions are not intended, however, to address specific investment risks to the value of individual portfolio securities. Rather, these provisions address business risks such as valuation or the risk that a fund's approved investment strategy is not being appropriately followed. The UCITS Directive and AIFMD do not specify senior management's responsibility for other security-level investment risks because integration of these material investment risks is part of the responsibilities of the investment team.

If ESMA determines that it is necessary to treat sustainability risk differently from other investment risks, we recommend instead clarifying that senior management should approve and review on a periodic basis the fund manager's policies and procedures around integration of material sustainability risks in the investment process.

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Q3: Do you see merit in expressly requiring or elaborating on the designation of a qualified person within the authorised entity responsible for the integration of sustainability risks and factors (*e.g.*, under Article 5 of the Commission Directive 2010/43/EU and Article 22 of the Commission Delegated Regulation (EU) 231/2013)?

We do not see merit in expressly requiring the designation of 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.

ESG integration is part of the investment process. The portfolio management team is best positioned to analyze the ESG factors affecting a particular investment and incorporate that analysis into investment selection, allocation, and stewardship. Requiring the designation of a single person would only encourage the separation of sustainability risk analysis from the investment process, which would be contrary to the purpose of ESG integration.

Having a specific designee responsible for ESG integration also would jeopardize skewing the overall risk assessment of an investment. Sustainability risk is only one of many risks that the portfolio management team may take into account in the investment process. As discussed in our response to Q1, the fact that a particular risk is conventionally classified as an ESG or sustainability risk will not be conclusive as to whether it is financially material or not.

Q4: Would you propose any other amendments to the provisions on organisational requirements in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

No, as described above, fund managers' internal control programs are not used to identify and manage security-level investment risks such as sustainability risk to the value of a particular investment. We provide more information in our response to Q5 around integration of sustainability risks into due diligence (*i.e.*, the investment process).

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Q5: Do you agree with the proposed amendments to provisions relating to due diligence included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

ESMA proposes adding language to the UCITS Directive Article 23 on due diligence that 'Member States shall require that management companies take into account sustainability risks and factors when complying with the [UCITS Art. 23 due diligence] requirements. . . .' 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 agree with ESMA's view that sustainability risks should be considered along with all other material risks and that, as part of their investment process, asset managers should identify, monitor, and manage material risks to their investments, including sustainability risks.

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 . . . .' Without this addition, the proposed text may not provide sufficient flexibility to accommodate different types of strategies, such as a money market fund or an index-based strategy where the manager does not have discretion to make investment selections beyond a particular security's inclusion and weighting in the index. Also, adding the term 'material' would distinguish material sustainability risks and factors from those that may not be material.

As ESMA notes, fund managers may take different approaches to analyzing sustainability risks. There is a wide range of approaches to ESG integration, and fund managers continue to refine their processes as they gain a better understanding of how to identify and manage material sustainability risk. For example, a fund manager may have an ESG integration oversight function that coordinates ESG-related inputs for portfolio management and research, with specific ESG risks monitored by the investment team at the individual company level, embedded within the team's investment thesis and arising from fundamental research.

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The investment team's analysis of sustainability risks and their materiality to an investment may be qualitative and may vary depending on the industry. For example, waste and hazardous materials management are more likely to be a material ESG risk for a company in the extractives and minerals processing industry than a company in the financial services industry.

In addition, we provide comments on some of the analysis accompanying ESMA's proposed changes. First, the approach described in paragraph 27, in particular, would go beyond a high-level principles-based approach. We are concerned that this level of detail would limit the diversity of approaches currently used by market participants. Some fund managers rely on third party ESG data and ratings providers to undertake the type of analysis described in paragraph 27 while others do not.

Given the significant limitations around ESG data, we urge ESMA to consider how the rules can be applied in a proportionate way. UCITS make investments globally and therefore any framework needs to take into consideration not only the current limitations in relation to data in Europe, but also differing data availability in other jurisdictions. For example, in Japan, we understand that only 500 out of 4,000 issuers are covered by ESG data providers. We also disagree with the suggestion in paragraph 28 that authorised entities should develop specific methodologies to process this data, and we emphasize the importance of avoiding a one-size-fits-all approach to any requirements around how portfolio managers integrate research inputs (such as ESG-related data) into the investment process.

With regard to paragraph 29, we underscore that engagement should be taken into account when considering whether 'the investment decisions on behalf of the UCITS or the AIF are carried out in compliance with the analysis performed [] on sustainability risks.' Many of our member firms view engagement as a powerful tool to address ESG risks and, in the case of passive strategies where managers have no investment discretion, it is the only option to address material sustainability risks.

Given this evolving landscape, policymakers at this stage should promote a principles-based approach to any regulation of due diligence and the investment process. This type of approach will accommodate different approaches to ESG integration as well as further developments in data and analytics and in the broader understanding of which ESG factors may be material to long-term investment returns.

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Q6: Do you see merit in further elaborating in the provisions above on the identification and ongoing monitoring of sustainability risks, factors and indicators that are material for the financial return of investments?

We do not see merit in further elaborating on the identification and ongoing monitoring of sustainability risks, factors, and indicators that are material for the financial return of investments. As discussed above, fund managers' approaches to ESG integration incorporate a broad spectrum of indicators and methodologies, many of which are fairly new and continuing to develop. Data and research on sustainability risks and factors often are difficult to obtain, inconsistent in terms of methodology or outcomes, and of varying quality. For example, there are large variations in ESG scoring and ratings across different ESG research providers. These challenges play a role in the evolving nature of sustainability risk assessments.

Q7: Do you agree with the proposed inclusion of recitals relating to conflicts of interest? Should the technical advice cover specific examples? If so, what would be specific examples of conflicts of interests that might arise in relation to the integration of sustainability risks and factors and should be covered in the advice?

ESMA proposes adding new recitals language to the UCITS Directive and AIFMD clarifying that, when identifying the types of conflicts of interest whose existence may damage the interests of a UCITS (or an AIF or its investors), management companies (or AIFMs) should include conflicts that may arise in relation to the integration of sustainability risks and factors.

Fund managers generally have comprehensive policies and procedures around how to manage and mitigate organisational conflicts of interest. Examples of these conflicts may include outside business activities that conflict with internal firm duties or firm interest; making investments in a company that also manages money for executives; brokerage practices; gifts and entertainment; or accepting personal fees or commissions not in the usual course of firm business.

Some of these organisational risks theoretically could arise in the context of the investment process (*e.g.,* if there is a personal relationship with a company). The conflict of interest requirements in the UCITS Directive and AIFMD are not intended to address security-level investment risks, however, and we do not anticipate conflicts of interest arising with respect to sustainability risk to a portfolio investment.

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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.

Q8: Would you propose any other amendment to the provisions on operating conditions in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risks and factors?

No. Fund managers have widely adopted ESG integration even without a regulatory mandate. In keeping with their duty to act in the best interest of investors, fund managers view ESG integration as a means of identifying investment opportunities, managing investment risk, and enhancing risk-adjusted returns.

Q9: Do you agree with the proposed amendments to provisions relating to risk management included above following a high-level and principles-based approach? If not, please elaborate on the reasons for preferring a more granular approach and describe how you would incorporate such view in the aforementioned provisions.

We agree with ESMA's view that sustainability risks should be considered along with all other material risks to investments that funds' portfolio managers identify, monitor, and manage. ESMA describes this process as 'an integrated due diligence and risk management approach.' It is important to clarify, however, that investment management and risk management are separate functions that serve different purposes.

The risk management program requirements in the UCITS Directive and AIFMD are required to be separate and distinct from the investment management process.[5] Fund managers' risk management programs are focused on strategic, operational, and financial business risks. The risk management program also covers overall fund-level risk (such as liquidity or market risk), but it is not intended to address specific investment risks to the value of individual portfolio securities. Sustainability risks often

[5] *See* Article 15 of Directive 2011/61/EU. *See also* Recital 53 of Commission Delegated Regulation (EU) No. 231/2013).

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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.

As discussed in our response to Q5, these types of security-level investment risks are addressed in due diligence, as part of a fund manager's investment process. Since the risk management program requirements in the UCITS Directive and AIFMD focus on business risks and fund-level risks, we recommend that ESMA instead focus its amendments on the due diligence requirements.

However, if ESMA determines that it is necessary to explicitly add sustainability risk to the UCITS Directive and AIFMD provisions, we recommend instead clarifying that portfolio managers should '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 . . . .'

Q10: Do you see merit in further specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks (*e.g.*, techniques, tools and arrangements enabling the assessment of sustainability risks, probability of occurrence and time horizon of sustainability risks with regard to the expected time of holding of the positions bearing the risks, quality of underlying data and methodologies etc.)?

No, fund managers' risk management programs are not used to identify and manage security-level investment risks such as sustainability risk to the value of a particular investment. We provide more information in our response to Q5 around integration of sustainability risks into due diligence (*i.e*., the investment process).

Q11: Do you see merit in amending risk management provisions relating to regular review of risk management policies and systems in order to more specifically refer to elements related to sustainability risks (e.g. quality of the arrangements, processes, techniques and data used, need for authorised entities to highlight the limitations, and demonstrate the absence of available alternatives)?

No, fund managers' risk management programs are not used to identify and manage security-level investment risks, such as sustainability risk, to the value of a particular investment. We provide more information in our response to Q5 around integration of sustainability risks into due diligence (*i.e*., the investment process).

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Q12: Would you propose any other amendment to the provisions on risk management in the Commission Directive 2010/43/EU or Commission Delegated Regulation (EU) 231/2013 as set out in Annex III to ensure the effective and adequate integration of sustainability risk and factors?

No, fund managers' risk management programs are not used to identify and manage security-level investment risks such as sustainability risk to the value of a particular investment. We provide more information in our response to Q5 around integration of sustainability risks into due diligence (*i.e.*, the investment process).

Q13: 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.

We are unable to estimate precisely the level of resources (financial and other) that would be required to implement and comply with the proposed changes. For context, however, we highlight that asset managers, asset owners, and issuers are already spending large amounts on obtaining ESG-related data, building processes, and reporting. For example, one recent estimate places total global spending on ESG data at $505 million in 2018, with expectations that it will reach $745 million by 2020.[6]

[6] *ESG Data: Mainstream Consumption, Bigger Spending* (9 January 2019), *available at* http://www.opimas.com/research/428/detail/.