BlackRock.

19 February 2019

European Securities and Markets Authority
103 rue de Grenelle
75345 Paris, France
For the attention of Salvatore Gnoni

Submitted online at www.esma.europa.eu

RE: Consultation on integrating sustainability risks and factors in MiFID II

Dear Salvatore,

BlackRock[1] is pleased to have the opportunity to respond ESMA's Consultation Paper on integrating sustainability risks and factors in MiFID II.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs. We are supportive of the aim to encourage increasing transparency in the field of sustainability risks and sustainable investment opportunities. We acknowledge the challenge of crafting regulatory requirements on integrating risks and factors in MiFID II given the variety of approaches to ESG factors and ESG preferences and the rapidly involving market.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of ESMA on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

We welcome the high-level principles-based approach proposed by ESMA which recognises the rapid pace of change in the EU's wider policy framework, the ongoing development of access to consistent data on sustainability risks which are critical to driving suitability assessments as well as the wide variety of ESG investor preferences.

Future innovation relies on a flexible rather than a prescriptive framework
At this stage in the policy cycle we recommend avoiding overly prescriptive rules given the different needs, approaches and ESG preferences expressed by investors and leave room for the new market standards to develop. In particular, we emphasise the difficulties in integrating detailed ESG criteria into standard industry disclosure templates such as the European MiFID Template given the current lack of consistency in and comparability of underlying concepts of ESG by market participants. Instead, at this stage we recommend only a targeted extension of the current industry reference framework backed up by greater qualitative disclosure of potential ESG objectives and/or management of ESG risks, reflecting the disclosure requirements of parallel EU legislative and regulatory initiatives.

Differentiate between sustainability at an individual product level and at a portfolio level
The proposed suitability guidelines link back into individual products with a specific ESG objective. As recognised in ESMA's existing suitability guidelines it is essential to recognise that many clients use the service of an investment adviser or a discretionary portfolio manager to construct a wider portfolio. Consequently, meeting a client's ESG objectives at portfolio level will require a blended approach which may include instruments with a specific ESG outcome, products which factor in ESG risks ("ESG aware products") and products which are needed to meet the client's other financial preferences. This approach recognises that distributors need flexibility and the ability to apply a range of different approaches when designing portfolios that meet both the desired financial outcomes and ESG preferences of their clients.

The importance of sequencing EU sustainability approaches which affect the provision of MiFID services
We also stress the importance of the correct sequencing of the different EU initiatives regarding sustainable finance. The interlinkage between the different proposals, especially with the disclosure and taxonomy proposals are crucial for the development of the overall Sustainable Finance Action Plan. We urge ESMA to ensure that its updated guidelines tie into the final version of these developments. For example, ESMA's parallel proposals on UCITS and AIFMD are likely to contribute significantly to reporting on the management of sustainability risks by investment funds which in turn feed into the ability of investment advisors and discretionary mangers to meet their clients' ESG preferences at a portfolio level.

Responses to individual questions

Organisational requirements

1. 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 welcome the high-level principle-based approach of adding the phrase "*Where ESG considerations are relevant for the provision of investment services to clients, firms should take them into account when complying with the above requirements*." We believe this approach leaves room and flexibility to the industry to adapt and further develop market standards.

In paragraph 6 ESMA refers to taking ESG considerations *correctly* into account. We believe the use of *correctly* is a little unfortunate. We recommend ESMA changes this to *appropriate*, to avoid indicating that there is a single right way of incorporating ESG considerations within processes, systems and controls.

ESMA references the need for sustainability training for staff along with skills and expertise – there is, however, little indication of how this connects to the existing detailed MiFID skills and expertise requirements. At this stage, we believe it would be useful for firms to consider and disclose to their NCAs how they ensure that their staff develop appropriate skills and expertise – the skills needed for a portfolio manager will, for example differ from those needed by client servicing teams.

2. 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 agree with the approach of avoiding prescriptive rules and applying a proportionate approach. We support this approach as it is unlikely that a one-size-fits-all treatment of incorporating ESG preferences will be appropriate to the variety of different risk management approaches that exist today. When considering setting the proposed changes against the range of MiFID investment services and instruments provided to clients, there are a number of circumstances in which ESG factors are unlikely to materially affect the provision of a MiFID service. It is preferable for investment firms to take into account environmental, social and governance factors where relevant or material to the provision of the relevant service to their clients.

We also recognise that a broad and proportionate approach will support the ongoing efforts to incorporate improvements in data availability into internal processes. We reiterate the importance of considering the interlinkage and sequencing of the different legislative proposals under the Sustainable Finance Action Plan before finalising ESMA's Guidelines. Of particular importance when considering the effectiveness of ESG factors on the provision of MiFID services is the quality of corporate reporting of investee companies. Improving the quality of non-financial reporting by issuers is beyond the scope of these Guidelines but it is critical to the development of ESG risk assessments which meet clients' needs. We would welcome recognition from ESMA of the impact the relative inconsistency and reliability of underlying data has on the provision of ESG related services.

In paragraph 11 the reference to the control functions carried out by Compliance and Internal Audit oversight fails to refer to other risk functions firms have in place. From an asset management perspective ESG/sustainability risk will primarily be considered by each individual portfolio management team and then from a portfolio and operational risk perspective as a second line of defence. The purpose of compliance and audit teams is to ensure the relevant teams have put in comprehensive risk processes and are adhering to these processes. The primary assessment of ESG/sustainability risks should therefore be carried out by investment and risk professionals.

3. 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?

We agree the main concern on conflicts of interest is to avoid the mis-selling of green-branded products. We do not see particular issues regarding this new recital on the consideration of the types of conflicts of interest arising in relation to the integration of sustainability risks and factors but suggest that the wording is integrated into existing conflict of interest provisions.

4. 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, as mentioned before we welcome a high-level principles-based approach and do not believe that any further amendments should be made to the MiFID II Delegated Regulation regarding organisational requirements.

<u>**Product governance**</u>

5. 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.

We note that there is a wider variety of existing national Ecolabels (or other variation of that theme, for example, SRI labels, etc.) that cover investment funds but do not believe that the market has come to a consensus on a label or labels which would support cross-border sales rather than domestic sales. While we have looked at a number of national or cross-border schemes in considering potential labelling efforts, to date we have not sought a label for any product that we market in Europe. The reasons include certification and audit processes that can be expensive and time-consuming and not scalable for cross-border processes; whereas for others, it is not clear that domestic investor preferences are closely aligned with the label criteria. Due to the nature of investment funds, investors participate in the economic benefits of the funds but also share in their costs and expenses. The costs of any labelling scheme will ultimately be borne by investors in the funds and product manufacturers need to ensure that investors in a fund would value the specific label such that they would be willing to pay a higher premium for the fund to obtain the label and comply with it.

That said, we do see merit in standardising a potential label on a pan-European basis. One of the reasons why national

labels can, on balance, look unattractive is because the label is relevant only to one country which limits its potential investor base and also potential economies of scale (e.g. reduction in costs borne by investors due to spreading fixed expenses across a higher number of fund investors). A pan-European labelling scheme should allow a product provider to scale investment products across a much wider European market and thus drive down the costs associated with the label.

We welcome moves to ensure that both product manufacturer and distributor take into account ESG preferences of the target market. However, we do not support linking ESG factors to the EU's taxonomy proposal in paragraph 8. We believe the EU's currently proposed classification is not the right tool to address ESG preferences in the product governance rules. While investors do request the ability to invest in ESG products, they frequently do not distinguish between different aspects of ESG such as climate mitigation and climate adaptation or between waste prevention and a healthy ecosystem in their investment preferences, even though at a societal level they may care deeply about these issues. The scope and applicability of the taxonomy is still under discussion and only covers environmental economic activities as such is not yet ready for inclusion in product governance disclosures. More importantly investors' ESG preferences go beyond economic activities and we could therefore not fully rely on this classification system to meet these preferences. Limiting the assessment to a number of tightly defined economic activities only would make it very complex for investors, distributors and advisors and overwhelm them with information they may not require.

In addition, the proposed approach does not appear to include the integration of ESG factors in investment research processes and portfolio construction. We believe the integration of ESG factors in investment research and portfolio construction processes can enhance long term risk adjusted returns. A binary approach to assessing products with either no ESG or specific ESG goals, and no option for ESG aware investment products which take ESG risks into account, does not reflect the development of ESG aware instruments which can be of considerable value when meeting investors' ESG preferences.

Finally, the data element is also critical here. Today the industry uses different data sources to consider ESG factors. Relying on data provided by third parties places a certain level of reliance on those parties' methodology and assessment criteria. Our experience is that these data sources may be incomplete, inaccurate or unavailable which could ultimately lead to an incomplete assessment of the ESG risks of a particular investment. However, as this space evolves and becomes more sophisticated, portfolio management teams will increasingly want the ability to use other data providers or other sources of data in order to assess ESG investments.

6. 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 welcome a principles-based approach leaving sufficient flexibility for implementation and market developments. Target market data is at the heart of information exchange between product manufacturers and distributors in the existing European MiFID Template (EMT). This machine-readable template assists the matching of manufacturers' products to distributor clients' needs, which is used throughout Europe by MiFID stakeholders. In practice, the industry will attempt to integrate these new requirements into the EMT. Nevertheless, as mentioned above we do not yet see how the categorisation of ESG factors according to taxonomy would work in practice.

In paragraph 8, ESMA intends the industry to use the 6 environmental objectives as currently laid out in the taxonomy and no reference is made to the criteria for social and governance factors. Assuming a similar number of criteria for each factor this would potentially lead to dozens of sub-categories of ESG criteria. There will need to be a common understanding of these criteria by all stakeholders which can be converted into a machine-readable format if they are to be used effectively in the EMT. It would require significant expansion of the EMT and does not accommodate the fact that many ESG products cover multiple factors. We do not believe investors would benefit from the industry taking on board this level of complexity and cost at this point, especially while investor ESG preferences remain so diverse.

Currently, we believe a more meaningful way of capturing ESG issues in the EMT would be a series of binary questions in combination with high quality qualitative disclosures by product manufacturers at a product level. We suggest at the first stage the manufacturer considers 3 binary questions that can be added to the template. For example:

1. Is the product ESG aware (ESG integration in investment process)? Yes/No. This would allow UCITS/AIF manufacturers to reflect the work conducted on ESMA's parallel work on how UCITS and AIFs should integrate sustainability in investment and risk management. The manufacturers of other MiFID instruments would answer this question as appropriate.
2. Does this product have an explicit ESG objective/ outcome? Yes/No
3. Does this product apply exclusionary ESG screens? Yes/No

At the second stage the distributor can interpret the combination of product governance comparable data from the above questions and factor in qualitative disclosures from the manufacturer on how the ESG integration, objectives or screens have been applied. This is likely in any case to tie in with distributors' existing due diligence processes. This information

can then be included in a comprehensive way to the end investors as part of the individual suitability assessment. Subsequently these binary questions and disclosures could also be complemented by applicable EU labels. Many institutional investors will also receive information back from asset managers on the implementation of investment policies under the Shareholders Rights Directive (SRD) and the scope of this reporting should be factored into ESMA's work.

The current MiFID product governance process also includes a requirement to feedback to the manufacturer on whether products have sold within the target market or not, but the feedback required is limited to a certain number of fields. Essentially for distributors this means they would have to report sales outside target market but only when their investor wants an ESG product and they sell them a non ESG one. This may mean for platforms that they will need a compulsory automated tick box where the investor will self-identify as wanting an ESG product and only ESG would be selectable. We also refer to our additional comments on the implications of this in Q7 below when a client requires the provision of a portfolio which considers ESG risks by the inclusion of ESG aware products in addition to the provision of individual ESG products on a stand-alone basis.

This conceptual analysis naturally depends on the final outcome of the EU's disclosure proposals and may need further review once these are known. We recommend ESMA consider linking the final disclosures agreement to the product governance section once finished and only if meaningful.

We would also like to emphasise that the product governance requirements apply to all MiFID instruments and we therefore recommend avoiding too prescriptive approach to make sure this works in practice for all products.

7. 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 to "clients' objectives and needs". We strongly support the comment that this should not lead to a 'negative target market' for those investors who do not have ESG objectives and needs. We would encourage ESMA to avoid including a negative target market for people that have broad ESG preferences. We believe this is important given that the MiFID service many investors require is that of investment advice or discretionary management over a whole portfolio of investments and not only in one single product. As mentioned in the Executive Summary, distributors need the flexibility to build portfolio that meet clients' risk profiles, financial outcomes and ESG preferences.

We also consider that the proposed case study does not reflect a viable investment product as it refers to a UCITS product investing primarily in unlisted or illiquid assets which would be ineligible for the UCITS framework. It would be rare for such an investment portfolio to be offered with both daily pricing and daily liquidity. We also believe that the underlying asset composition would lead to a higher risk indicator noting that the KIID risk indicator is a volatility-based indicator. ESG investments do not necessarily exhibit the reduced volatility implied by the example. Furthermore, it is unclear what the "green project" certificate would be based on. We therefore do not believe that this specific case study will be helpful and suggest it is deleted.

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

We do not believe extra guidance is required.

9. 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.

We question the purpose of a single indicator. If as discussed in our answer to Question 6 the aim is to identify whether ESG criteria are taken into account or not or whether there is an ESG objective or not, then we would support the concept of a single indicator. If the aim is to provide a blended ESG risk score, then we do not believe that the relevant ESG criteria can usefully be narrowed down to a single indicator. Narrowing down ESG preferences to one single indicator could be too prescriptive and restrictive and such it is not a proportionate approach given the speed of market developments. As outlined in Q6, we believe the product governance requirements should be addressed by responses to a series of high-level questions accompanied by qualitative disclosures.

The detail of ESG specific issues means it is near impossible for anyone other than an adviser to match a product to individual investor preferences. This also recognises that sustainability risk is not an aggregate or horizontal risk, but something that is idiosyncratic to a particular investment. In addition, the level of intermediation in distribution channels

means many products are sold through a range of channels which do not permit such a detailed analysis of investor needs. In terms of investor protection ESMA should alternatively consider the product controls, disclosure and management responsibilities under UCITS, AIFMD and SRD.

Suitability

10. 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.

11. 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?

We believe ESMA has addressed one of the key issues of cognitive distortion resulting from the multiple understanding of what constitutes ESG. In building an investor-centric framework, it is important to recognise that different types of investors have widely varying needs, approaches and preferences. If we ask an end retail investor whether they want a sustainable investment, many may say yes – but it is unlikely that they, or even their advisors, might fully understand how that choice may impact their financial goals.

We welcome the two-stage ranking process where investment firms first assess the investor's investment objectives, time horizon and individual circumstances, before asking the client for his or her potential ESG preferences. This process is a potentially useful way of reinforcing existing processes rather than having to totally rebuild them. This is particularly important given the multiple IT solutions put in place to meet the MiFID II suitability requirements.

Consistent with our answer to question 5, we do not believe that ESMA should mandate the collection of information from clients and assessment of ESG preferences on the basis of the EU's taxonomy as these are unlikely to be in line with clients' approaches.

As mentioned in question 7, we agree with paragraph 14 that ESG products should not be unsuitable for clients without ESG preferences and that investment that are not categorised ESG should automatically be deemed unsuitable for clients who have expressed ESG preferences. Products which integrate ESG risks into their investment approach, for example, could be suitable for both categories of investor. Therefore, we also think it could be useful to add an example of investment products managed based on ESG risks and qualitative disclosures in paragraph 12.

12. 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.

Please see answer to question 9. As ESG criteria are highly interlinked we do not see the benefit of a category by category assessment of ESG.

13. Do you agree with the suggested approach and the amendments to paragraph 70 of the suitability guidelines?

Yes, we agree with this high-level approach. This approach seems to include the different existing market practices regarding ESG factors. We also note the Commission's clarification in the draft MiFID Delegated Act sets out that that a new suitability assessment for existing contracts will generally not be necessary (see Recital 8).

14. 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.

At this stage, given the number of variables in the process and interaction with other EU initiatives we cannot provide a meaningful statement on cost.