

4 June 2019

ESMA Technical Advice on Integrating Sustainability Risks and Factors in MiFID II

Background

As explained in the [MFSA Circular](#) which was issued on 21st December 2018, ESMA published a Consultation Paper on the draft technical advice on integrating sustainability risks and factors in MiFID II, in order to explain its rationale and gather input from stakeholders. The consultation period closed on 19th February 2019.

This Consultation Paper was primarily of interest to Competent Authorities, Investment Firms and Credit Institutions performing investment services and activities. This Consultation Paper covered the topics on which the Commission has requested ESMA to provide technical advice, namely: (i) Organisational Requirements; (ii) Risk Management and (iii) Product Governance. It also included suggested amendments to ESMA Guidelines on MiFID II Product Governance Requirements and ESMA Guidelines on Certain Aspects of the MiFID II Suitability Requirements.

ESMA noted that further changes to MiFID II Delegated Acts might be required in the light of the newly proposed Regulation setting out Disclosure Requirements on Sustainable Finance. ESMA will deliver its technical advice to the Commission which would then adopt updated MiFID II Delegated Acts. Once adopted by the Commission, the Delegated Acts will enter into force after their publication in the Official Journal.

Changes Proposed in ESMA's Technical Advice

In view of the fact that amendments to MiFID II Delegated Acts might be required, ESMA proposed the following changes in its [technical advice](#):

Organisational Requirements

ESMA believes that through the amendment of Article 21 of MiFID II Delegated Regulation, investment firms would be expected to incorporate environmental, social and governance considerations within their processes, systems and controls in order to ensure the investment and advisory process correctly takes them into account. Therefore, ESMA has confirmed its position and content of the technical advice with the suggested amendment to Article 21 of MiFID II Delegated Regulation.

Risk Management

ESMA has confirmed the content of its advice on the explicit referral to sustainability risks in Article 23 of MiFID II Delegated Regulation deemed consistent with the EU Commission's

mandate to require investment firms to integrate sustainability risks within their risk management systems and procedures. A new recital will be added to MiFID II Regulation confirming the position expressed in the Consultation Paper that both the Compliance Function and Internal Audit are expected to consider issues related to sustainability risks. The new recital **will also refer to the responsibilities of the investment firms' Senior Management.**

Conflicts of Interest

ESMA considers it important to introduce in MiFID II Delegated Regulation a clear reference to the need for investment firms to identify conflicts of interest whose existence may damage the interests of a client, and that in doing so such firms should include those that may stem from the distribution of environmentally sustainable investments, social investments or good governance investments. Also, ESMA considers that the addition of a new recital 59 (bis) to MiFID II Delegated Regulation is important to ensure that investment firms have in place appropriate arrangements to ensure that the inclusion of environmental, social and governance considerations in the advisory process does not lead to mis-selling practices or misrepresentations and does not damage the interest of the client.

Product Governance

ESMA considers that both the manufacturer and distributor should take into account environmental, social and governance preferences or considerations while identifying the target markets for the financial instruments they manufacture or distribute. In this respect, ESMA confirmed its advice on the proposed amendments to Articles 9 and 10 of MiFID II Delegated Directive as well as to the Guidelines on MiFID II Product Governance Requirements. It is proposed that amendments will be carried out to paragraphs 9, 11 and 14 of Article 9 as indicated hereunder:

- **Paragraph 9 introduces the manufacturer's obligation to identify the target market for the investment products it manufactures.** ESMA proposed an explicit reference to environmental, social and governance preferences for manufacturers in specifying the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible with.
- Paragraph 11 requires manufacturers to perform the target market assessment in consideration of the respective product's risk/reward profile and (beneficial) product features. ESMA proposed to make it explicit at this point, that this assessment should also cover the environmental, social and governance characteristics of financial instruments.
- **Paragraph 14 covers the manufacturer's periodic review requirement of the financial instruments it manufactures.** In the context of this review, manufacturers should also **explicitly take clients' environmental, social and governance preferences into account.**

The proposed amendments to Article 10 (covering the requirements for the distributor) follow the same approach as the proposals for Article 9. ESMA proposed to include an explicit reference

to environmental, social and governance preferences in paragraph 2 (initial target market assessment) and paragraph 5 (review requirement).

Similarly, ESMA proposed a high-level approach on amending the Guidelines. It is being proposed that the section relating to 'client's objectives and needs' of Guideline 18(e) should be amended. ESMA has also included a new case study on the target market for a green investment product in order to provide further clarification on the application of the revised guidelines.

Contacts

Any queries or requests for clarifications on the contents of this Circular should be addressed to the Conduct Supervision on offsiteinv@mfsa.com.mt.