

DDV Response to ESMA Consultation on integrating sustainability risks and factors in MiFID II

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The Deutscher Derivate Verband (DDV), the German Derivatives Association, is the industry representative body for the leading issuers of derivative securities in Germany. It represents more than 90 percent of the German structured products market, including issuers such as BayernLB, BNP Paribas, Citigroup, Commerzbank, DekaBank, Deutsche Bank, DZ BANK, Goldman Sachs, Helaba, HSBC Trinkaus, HypoVereinsbank, LBBW, Morgan Stanley, Société Générale, UBS and Vontobel. Furthermore, the Association's work is supported by seventeen sponsoring members, which include the Stuttgart and Frankfurt Exchanges, Baader Bank, the direct banks comdirect bank, Consorsbank, DAB Bank, flatex, ING-DiBa and S Broker, as well as finance portals and other service providers.

The DDV welcomes the opportunity to respond to the present ESMA consultation on integrating sustainability risks and factors in MiFID II. The DDV recognises that aligning the real economy with sustainability is one of most important and pressing challenges of today's society. Given the central role of financial markets, it is understandable that they have been identified as a potentially effective leverage mechanism to reach this goal. However, what is most important is that financial market participants proceed in conjunction with the transformation process of the manufacturing and service industries. Financial market regulation cannot and should not replace the superordinate societal consensus of what is considered sustainable or unsustainable, as reflected in proper environmental policies or – particularly in the context of the sustainable finance agenda – best market practice.

In addition, the DDV urges financial regulators and supervisors not to lose sight of the overall objective of “mainstreaming” the sustainability agenda, taking into account the full spectrum of sustainability assessment methods currently available in the market. This is particularly important in the case of retail investment products in order not to harm investor protection, for example through an overstretching of incentives to invest into sustainable assets while potentially jeopardising other very important investment principles – first and foremost risk diversification. This could be the case, for instance, with a too narrow focus on impact investments.

The DDV understands that the present consultation tackles several issues with a wider focus than solely the manufacturing of financial products. Here, we limit ourselves to providing feedback on those questions relevant to the manufacturing and marketing of financial products from the perspective of the product manufacturer.

Having said that, the DDV particularly welcomes ESMA's overall pragmatic approach, especially at this early stage of the development of the sustainable finance agenda. We agree with ESMA that any adaptation of MiFID II requirements should tend to be principle-based and proportionate, taking into account the size, nature, scale and complexity of the activities.

Nevertheless, we are concerned regarding selected items in the present consultation paper. We have addressed these in the answers to the individual questions below:

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.

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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.

As far as the manufacturing and marketing of structured investment products is concerned, we would like to stress that structured products like investment certificates and warrants are passive investment products. As such, any product-related risk management can only take place while setting up and (actively) selling such products, but not during their lifetime. In addition, only ESG factors considered to be material for the financial position of the investor should be relevant, as reflected in the definition of “sustainability risk” in the ESMA consultation paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD (see para. 17 on page 7).

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?

It is not clear to us what kind of conflict of interest linked to ESG considerations could arise that is not otherwise addressed by the regulatory requirements that are already in place. In general, we are of the opinion that, prior to laying out the regulatory details, it should be made clear which specific problem is to be addressed. The implementation of MiFID II was, and still is, a significant burden on investment firms, and in many cases it is still not apparent how investors specifically profit from these rules. In our opinion, this is largely due to the fact that there were no proper market research and impact assessments conducted prior to formulating these rules.

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.

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.

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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.

The DDV particularly welcomes ESMA's principle-based approach and the inclusion of a simple reference to "ESG preferences". Especially in a highly automated environment, it is of particular importance that regulatory requirements following the same or related objectives are designed as homogeneously and simply as possible. Excessive regulatory details should be avoided in the interest of smooth integration into existing processes and (IT) systems with the ultimate objective of fostering investor and product manufacturer acceptance of the sustainability agenda.

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 generally agree with the proposed changes to the ESMA Guidelines. However, we would like to provide comment on a couple of issues reflected in the reasoning of the proposed amendments.

We understand the text "(where relevant)" in such way that it is at the discretion of manufacturers to decide whether or not a specific product can and should be labelled as ESG. Only in these cases are investment firms obliged to fulfil the amended Article 9(11) of the MiFID II Delegated Directive by setting up, for example, respective screening processes for underlying assets. We disagree with the ESMA interpretation stated in para. 10, p. 14-15 of the CP that "positive" ESG characteristics of a product shall be identified. Without any discretion of the product manufacturer to decide whether a product in principle can and should be potentially labelled as "ESG positive", the proposed amendment would constitute a disproportionate burden. The proposed changes to the MiFID II Delegated Regulation on the topic of suitability provides incentives to investors to clearly state ESG preferences. Product manufacturers will certainly respond to articulated needs without being obliged to assess ESG characteristics in those cases where these characteristics are most probably less relevant or not relevant at all. This might be the case, for example, where a client pursues a hedging rather than investment strategy.

In addition, we consider the approach outlined in para. 8, p. 14 of the CP to be too complex. We question clients' ability to clearly state such specific preferences. Retail investors in particular are not and will not be familiar in the near future (if ever) with the extremely detailed taxonomy regarding the different ESG themes like "pollution prevention and control" and "protection of healthy ecosystems" alongside the different methodologies like negative screening or Best-in-Class assessments. The taxonomy also seems to put its focus on a rather limited range of presently available sustainability assessment approaches like thematic and impact investment schemes. In order to ensure that a broad investor base can profit from ESG investments while not jeopardising other investment needs (most importantly risk diversification), the product governance requirements should not "favour" specific approaches, but rather be open to the whole range of possible approaches that are already available in the market, including, for instance, negative screening and Best-in-Class assessments.

Besides, given the importance of determining which products are eligible for "ESG preferences" or "ESG considerations" it is key for both supervisors and market participants to have a common understanding of the relevant regulatory benchmark. In this context, we would ask ESMA to review its referencing to the EU taxonomy and the Commission's Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (hereinafter "**Taxonomy Regulation**") as set out under para. 8, p. 14 of the CP. In our view, these references do not match with the definition of

“sustainable investment” pursuant to Art. 1 (1) of the Draft “Commission Delegated Regulation (EU) amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management”. The definition given there, refers to the notion of “sustainable investments” as defined in Art. 2 (o) (i) of the forthcoming Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (hereinafter “**Disclosure Regulation**”) and not to the definition of “sustainable investments” in the Taxonomy Regulation. Both definitions are – at least for the time being – not identical: Whereas the Taxonomy Regulation requires that a sustainable investment “**funds**” one or more economic activities that qualify under this Regulation as environmentally sustainable” (Art. 2 (1) (a)), the Disclosure Regulation foresees that an investment qualifies as “sustainable” if it is an “**investment(s) in an economic activity** that contributes to an environmental objective, including an environmentally sustainable investment as defined in Art. 2 of the Taxonomy Regulation”. Thus, the definition of “sustainable investment” given in the Disclosure Regulation appears to be broader and less strict than the definition in the Taxonomy Regulation. Further, the Disclosure Regulation – unlike the Taxonomy Regulation – does not provide for any Level 2 specification of the notion “sustainable investment”. Against this background, we would welcome if ESMA could scrutinize and clarify this topic, e.g. in its Feedback Statement to this CP.

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

No, we do not think that any further guidance is needed at this early stage, if at all. In general, we are of the opinion that prior to laying out regulatory details it should be made clear which specific problem is to be addressed, based on empirical evidence (e.g. through thorough impact assessments). In this context, it is not clear to us which specific problem is addressed with the elements listed in para. 15, p. 15-16 of the CP.

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.

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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.

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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?

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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.

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

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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 relevant²¹.

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