association of the luxembourg fund industry

19 February 2019

**ALFI's comments on ESMA's consultation paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD**

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The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

ALFI has been at the forefront of actively promoting sustainable finance opportunities for asset managers. 'Responsible Investing' is a major pillar of the Luxembourg investment fund industry and ALFI firmly believes that asset managers can play a key role in this area. ALFI believes that providing transparency and clarity to investors is key for the further development of this area. This is why the association was a founding member of Luxflag, the Luxembourg Fund Labelling Agency in 2006.

## 1. General comments

ALFI strongly supports the initiative of the Commission to promote sustainable finance. However, we would like to point out that ALFI commented in October 2018 [1] that the proposal required certain adjustments and clarifications for it not to be a missed opportunity. The scope and definitions in the proposal were ALFI's main concerns. Indeed, while "sustainability risk" is at the core of the proposal (in last year's consultation) it was not defined. We are therefore pleased that ESMA has proposed a definition in the current consultation on integrating sustainability risks and factors in the UCITS Directive and AIFMD. Indeed, a definition of "sustainability risk" is key as the concept needs to be defined because all market participants cannot be expected to understand it – at least not in the same manner.

Generally speaking, ALFI agrees with ESMA's suggestions to integrate sustainability risks and factors in the UCITS Directive and AIFMD through a high-level principle based-approach.

[1] ALFI's comments on the European Commission's Proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, October 2018

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**Answers to questions**

**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?**

As mentioned in the introduction, we are pleased that ESMA has proposed a definition in the current consultation. We would however like to specify that, in our opinion, the definition of sustainable risk should refer to risks that are "material" to the fund's investment portfolio. Sustainable risk should be treated as any other risk and not being singled out. In line with the UCITS and AIFMD level 2 measures, sustainable risk should therefore be limited to "material sustainable risk". Articles 38 of Commission Directive 2010/43 and article 40 of the AIFMR both refer to the materiality of the risks the investment fund is or might be subject to.

We also strongly recommend to add a definition of "sustainability factors", using the definition of ESG factors under paragraph 16.

It is important for these two definitions to be inserted in the proposed changes to the level 2.

**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 regards the organisational requirements, we deem it paramount that the industry is not burdened with additional human and technical resources. ESMA regularly refers in this consultation to the "high-level and principles-based approach" it undertook and we certainly agree with this approach.

We believe that the UCITS and the AIFMD framework already have a suitable framework to manage sustainability risk. A differentiated treatment of the sustainability risk might even be counter-productive, as it could leave to the wrong impression that sustainability risk is given a higher priority than other risks, such as market risk or liquidity risk.

**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)?**

The wording currently proposed reads: "AIFMs shall take into account sustainability risks and factors when complying with the requirements laid down in the first subparagraph.", which in turn refers to paragraph 1 which outlines that "AIFMs shall employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them". The same being applicable to UCITS.

ALFI believes that sustainability risk form part of the risk management function and therefore would be embedded in the actually risk management function. We do not believe there to be the need for the designation of another "qualified person […] responsible for the integration of sustainability risks". As regards sustainability factors, these factors could form part of the investment/portfolio management process.

Either way, the integration of sustainability risks and sustainability factors would already be "monitored" by control functions currently in place at AIF and UCITS, the risk management in a first step and the compliance function in a second/last step.

If ESMA nevertheless wants to elaborate on the designation of a qualified person, as rightly pointed out in this consultation: this needs to be done in a way that is appropriate to the size, nature, scope and complexity of the asset manager's activities and in line with the relevant strategies pursued. ALFI considers that it should be left to the discretion of the asset manager, depending on their size, nature, scope and complexity, to decide the appropriateness of who within their organisation should be accountable for the monitoring the sustainability risks and factors. We also believe that the designation of a qualified person should not lead to the conclusion that additional human and technical resources would be required.

**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?**

See our previous answer.

**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.**

We agree with the proposed amendments to provisions relating to due diligence following a high-level and principles-based approach.

We think that the level of due diligence to be required for integration of sustainability risk should be consistent with the general due diligence process. In order to remain consistent with the investment analysis approach adopted by fund managers for other risk elements, it would be helpful to clarify that such material impact should be assessed on the basis of a portfolio approach, i.e. taking into account the relevance of sustainability risk associated with specific investments for the overall fund portfolio.

**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?**

As explained in our reply to Q5 above, we would see merit in clarifying that investment analyses in terms of sustainability risk should be performed with a focus on the contribution of a specific investment/position to the overall portfolio. Otherwise we do not see the need for further specifications of the relevant provisions since we believe that the level of due diligence and subsequent monitoring for sustainability factors should be the same as for any other factors which might lead to material risks

**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?**

Sustainability risk should not be specifically stressed in order to avoid the impression that it is of particular relevance for the fund managers' operations. Therefore, we do not see the need for a specific recital on identification of potential conflicts of interest with regard to integration of sustainability risk.

**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?**

As stated before, we strongly believe that more detailed requirements would not be in line with the principle-based approach which is the right way forward at this stage.

**Q9: Do you agree with the proposed amendments to provisions relating to the 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.**

Yes, we agree with the proposed amendments. UCITS and AIFMD are principle based regulations and thus a risk manager/ a Management Company should consider all risk (categories) relevant to the fund in the fund's risk management framework. ALFI believes that the proposed amendments are in line with other risk factors/categories.

**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.)?**

ALFI does not see the merit in specifying the content of the risk management policy by expressly listing key elements for the effective integration of sustainability risks. Based also on feedback to question 9 above, we do not see the need to further specify key elements of sustainability risk at the level of primary legislation.

The definition of the techniques, measures and tools applied for the assessment of sustainability risks should be in line with the risk profile of the fund, which is standard practice in Luxembourg subject to the supervision of the CSSF. The approval of such risk profiles is part of the responsibility of the board of the Management Company of a fund / IFM. To implement the measures/tools etc. is the responsibility of the senior management (in Luxembourg also the "Conducting Officers") and the risk manager of the fund.

**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, ALFI does not recommend 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.

**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?**

We would recommend adding" …sustainability **where relevant**…" to the amended Articles 38 and 40.

**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.**

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