

19 February 2019

European Securities and Markets Authority
103 Rue de Grenelle
75345 Paris
France

Submitted online at www.esma.europa.eu

RE: Consultation on Integrating sustainability risks and factors in the UCITS Directive and AIFMD

BlackRock¹ is pleased to have the opportunity to respond to this consultation. We are supportive of the aim to encourage greater integration of ESG/ sustainability considerations and are generally supportive of ESMA's approach as set out in the consultation paper.

We believe that sustainability- and ESG-related inputs can be material and important considerations in investment and risk management processes, and hence integration of these considerations is consistent with asset managers' existing responsibilities to exercise due care and skill when acting as a fiduciary for asset owners. We are therefore pleased to see the proposed requirements build upon existing principles in UCITS and AIFMD.

However, we recognise the challenges in crafting regulatory requirements related to the integration of sustainability in investment and risk management as it's unlikely that a one-size-fits-all approach will be appropriate to the huge variety of different investment approaches that exist today.

For example, asset managers have widely varying levels of flexibility when it comes to selecting a portfolio's investments – from index-based investments where they have no ability to change portfolio construction above and beyond a particular security's inclusion and weighting in the underlying index versus an active strategy where the manager is responsible for investment selection within the parameters of the mandate. There are also investment approaches which are built around specific quantitative factors (for example, price momentum or value-based strategies) where the manager follows an explicit strategy that limits what factors and potential inputs their investment decisions are based on.

We are therefore pleased to see ESMA recognise the need for requirements to be principles-based to allow for the adaptability of the rules to meet the wide variety of circumstances and applications in which they will be expected to apply, and we are broadly supportive of the approach ESMA has outlined to incorporating sustainability as a high-level requirement into the related requirements.

¹ BlackRock is one of the world's leading asset managers; managing 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.

In brief summary of the key points that we raise in our response to the consultation:

- **Definition of ‘sustainability risk’ is critical**

We see the definition of ‘sustainability risk’ as perhaps the central question at the heart of this consultation. With the proper definition of the term – in our mind, linked to the impact of sustainability- or ESG-related considerations on the financial value of a specific investment position – the suggested additions to the governance, investment and risk management sections build on fund managers’ duties and incorporate sustainability in a way that preserves and enhances their alignment of interest with end-investors. However, with an improper definition, the requirements elsewhere in the suggested amendments to the Directives could be difficult to comply with, add unnecessary costs without delivering investor benefit and potentially even create misalignments of interests between fund managers and the fund’s investors.

- **‘Integrating’ versus ‘adding’ sustainability as a function**

We believe the best way to incorporate sustainability into investment and risk management processes is by integrating it into the existing processes and controls, rather than requiring it to be added as a stand-alone function or input. In this regard, we believe the proposed additions to the due diligence requirements (subject to minor clarifications we outline in our response) are the right approach to integrating sustainability into investment management processes. We believe this approach should be followed for the requirements around risk management as well, where the proposed amendments could be interpreted as creating an extra ‘pillar’ of risk management, rather than requiring the integration of sustainability- or ESG-related inputs into existing risk management assessments.

- **Avoiding duplication in governance arrangements**

The changes suggested in the investment and risk management sections of the consultation paper will automatically lead to increased responsibility of the manager to understand and oversee the expansion of inputs that would be required in those functions. We believe the explicit requirement of additional dedicated sustainability resources and expertise in the governance requirements of the management company/ AIFM could be duplicative and unnecessary. For example, oversight of all the activities of portfolio management and risk management is already a standard requirement. As with our view that the best route for embedding sustainability is ‘integrating’ it into existing processes rather than requiring the ‘addition’ of new stand-alone functions, we see the addition of sustainability as suggested elsewhere in the consultation as already requiring an evolution of manager expertise and oversight without the need to require new dedicated resources – an approach we would support.

We have not answered each question explicitly, but rather separated out our comments around the key sections in the consultation paper and the corresponding questions:

Defining ‘sustainability risks’

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 believe this is perhaps the most important question in the consultation. The ability to implement the process and governance requirements set out in the paper are contingent on an appropriate definition of sustainability risks.

Generally speaking, we agree ESMA has taken the right approach to defining ‘sustainability risks’ as tied to the value of investments: sustainability-related or ESG-related factors can be material drivers of the value of a particular investment, and they therefore can be important considerations, alongside other factors, in assessing investment risks and opportunities.

However, we think the concept of ‘sustainability risk’ is best understood as the impact of idiosyncratic ESG factors or broader sustainability-related macro themes on *specific investments* – not as an aggregated risk at the portfolio-level for a fund or other portfolio. This is an important point that colours our response to other questions in the consultation, and we think this could be made more explicit in the final definition. We comment further on the assessment of broader portfolio risk and ESG investor preferences in our response to ESMA’s consultation on integrating sustainability risks and factors in MiFID II.

Finally, we think explicit reference to the materiality of ESG risks to the particular investment is key. For example, the same piece of sustainability-related data to a particular company may be material to some portfolios and not to others, depending on the investment strategy, time horizon, end-investor ESG preferences and risk profile.

Taking into account the above, we would slightly modify the framing of ‘sustainability risks’ in the consultation paper to say that they ‘could be understood as the risk of fluctuation in value of particular investment positions in a fund’s portfolio due to material ESG factors as appropriate to the investment strategy of the portfolio.’

Organisational requirements:

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.

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 disagree that there should be some responsibility at the management company/ AIFM level for ensuring the integration of sustainability risks and factors, however, we are unsure that this should be seen as an entirely new stand-alone



requirement, which we believe could imply some duplication of requirements and resources.

If properly integrated in the investment and risk management processes, as is addressed elsewhere in the consultation paper, we believe the existing requirements of management companies/ AIFMs to adequately oversee and resource the processes and functions covered therein should suffice, as these would include the sustainability angle in the amended requirements.

For example, under Article 9 of the UCITS Directive “Control by Senior Management and Supervisory Function”, subparagraph 2 (a)-(f) already set out a comprehensive duty to oversee the investment and risk management functions, whether performed internally or delegated to third parties. The amendments proposed elsewhere in this consultation paper to Articles 23, 38 and 40 of the UCITS Delegated Acts already explicitly require the integration of sustainability considerations, and we think therefore, would be implicitly covered under the responsibilities set out in Art 9.2(a)-(f) without the need to add (g) specifically. In practice, individuals who are responsible as designated persons/conducting officers for oversight of portfolio management and risk management should include sustainability risks into their oversight role and consider what additional resources or skill sets they require.

We believe it is most appropriate to embed sustainability considerations directly in the investment and risk management functions, as opposed to automatically requiring an additional dedicated resource at the management company level.

Investment management

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 do agree that the principles contained herein should follow a high-level and principles-based approach to accommodate the significant variances in different investment strategies and approaches.

However, we would prefer to see it made more explicit that the requirement to integrate sustainability risks and factors is as appropriate to the strategy of the fund or portfolio. For example, the proposed amendment to require management companies/ AIFMs to take into account sustainability risks and factors when complying with their existing obligations may not be flexible enough to accommodate index-based strategies where managers do not have discretion to make investment selections above and beyond the particular security's inclusion and weighting in the index.

Additionally, we believe there should be explicit reference to materiality in the final requirements for reasons outlined in our response to Q1. We would suggest amending the proposed additions as follows:

[Management companies /AIFMs shall be required to] “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” [...]



Risk management

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.

Again, broadly speaking, we do agree that material sustainability risks should factor in to risk management policies and processes as and where appropriate. However, the proposed amendments seem to suggest that sustainability risk exists at the fund level, whereas we would see sustainability-related risks as generally specific to individual investment positions. Outside of portfolios that seek to achieve a particular sustainability-related objective (or remain within a particular sustainability-related parameter, such as a carbon-emissions related metric), it is unclear to us how sustainability risks could be meaningfully aggregated and managed at the portfolio level.

The proposed amendment could be interpreted as suggesting that sustainability risk is effectively a stand-alone pillar of risk management, whereas we would see material sustainability-related risks as security-level inputs to informing various views of risk (market, liquidity, credit, counterparty risk, etc.). In cases where the portfolio seeks to achieve a particular sustainability-related objective, an aggregate view of the portfolio-level sustainability risks and metrics is appropriate to monitor the related performance risks.

In short, we think the best approach to incorporating sustainability into risk management rules is one of integrating these considerations into existing risk assessments as appropriate, as opposed to adding requirements to assess sustainability risks on their own. As such, we think that a similar amendment as we have suggested above in the investment management section might be the most appropriate:

[Management companies/AIFMs 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” [paragraph(s)]