

ICI Global's response to the Commission's draft delegated acts that modify the UCITS Directive framework with respect to sustainability risks and factors

ICI Global¹ appreciates the opportunity to provide feedback on the European Commission's draft delegated acts that modify the UCITS Directive provisions around due diligence, organisational requirements, conflicts of interest, and conduct of business and risk management for UCITS management companies (UCITS Draft DAs).²

We agree with the Commission's view that sustainability risks should be considered along with all other material risks and that, as part of their investment process, asset managers should identify, monitor, and manage material risks to their investments, including sustainability risks. We have significant concerns, however, about the delegated act amendment that adds consideration of adverse impact to the UCITS due diligence requirements and urge the Commission to remove this requirement from the draft. We also question the amendments to the UCITS provisions on organisational requirements, senior management responsibilities, conflicts of interest, and risk management. Those provisions are not relevant for achieving the Commission's aim of integrating sustainability risk into the investment process and should not be amended.

We urge the Commission to eliminate the UCITS Draft DAs Article 1(7) that adds consideration of adverse impact to the UCITS due diligence requirements because stakeholders have not had an adequate opportunity to provide views on this very significant and novel provision and no meaningful cost benefit analysis has been performed.

This provision adds a significant, substantive requirement via level 2 legislation, without undergoing a transparent, consultative process. The Commission's draft notes that consultations were undertaken prior to adoption of the delegated act. However, the public consultation between 19 December 2018

¹ [ICI Global](#) carries out the international work of the [Investment Company Institute](#), the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$31.3 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

² See COMMISSION DELEGATED DIRECTIVE (EU) .../ of XXX amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS), available at <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11959-Integration-of-sustainability-risks-and-factors-for-undertakings-for-collective-investment-in-transferable-securities->.

and 19 February 2019 did not include this provision on adverse impact in due diligence requirements.³ This provision was added after that consultation had closed.⁴

The adverse impact due diligence provision is significant because it has the potential to conflict with an asset manager's ability to act in a client's best interest. Given its fiduciary agency business model, a UCITS manager must invest a fund's assets in a manner that it believes will best achieve the fund's stated investment objectives (as set forth in the fund documentation). This inclusion of adverse sustainability impact could raise the question of how these new obligations interact with an asset manager's duty to act in a client's best interest.

Moreover, the provisions on the consideration of principal adverse impact on sustainability factors for UCITS managers are overly broad and the appropriate changes for UCITS managers have already been adopted in the SFDR. SFDR Article 4 requires financial market participants, including UCITS managers when they consider principal adverse impacts of investment decisions on sustainability factors, to disclose a statement on due diligence policies on those impacts, taking due account of their size, the nature and scale of their activities, and the types of financial products they make available. Recital 6 of the UCITS Draft DAs notes that this provision is intended to 'ensure consistency,' but the relevant changes to UCITS managers have already been made in the SFDR.

If the Commission determines to amend explicitly the UCITS due diligence requirements, we recommend clarifying that management companies should 'take into account such principal adverse impacts *as appropriate to the investment strategy of the portfolio* when complying with the requirements set out in paragraphs 1 to 4 of this Article.' This will address the significant concerns about potential conflicts with investor mandates.

The provisions on organisational requirements, senior management responsibilities, conflicts of interest, and risk management are not relevant for achieving the Commission's aim of integrating sustainability risk into the investment process and should not be amended.

³ See ESMA consultation paper on integrating sustainability risks and factors in the UCITS Directive and AIFMD (19 December 2018), available at https://www.esma.europa.eu/sites/default/files/library/esma34-45-569_consultation_paper_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_aifmd.pdf.

⁴ See ESMA's technical advice to the Commission (30 April 2019), available at <https://www.esma.europa.eu/document/final-report-integrating-sustainability-risks-and-factors-in-ucits-directive-and-aifmd>.

We recommend that the Commission focus this delegated act on its aim of integrating sustainability risk into the investment process.⁵ Many of the listed provisions do not address investment risk and therefore are not relevant to achieving the Commission's aim.

Risks to a particular investment (such as sustainability risk) are addressed within the investment process (*i.e.*, due diligence)—not in fund managers' internal control programs that are designed to address firm-level and fund-level business risks. It is important to distinguish between the function of the investment team (which includes its own investment risk infrastructure) that is responsible for ESG integration and assessment of the risk each investment presents, and the independent functions of compliance and audit that ensure that the investment processes accurately reflect the funds' investment strategies and other ESG disclosures that fund managers provide to investors.

We therefore urge the Commission to amend only those provisions that are relevant to achieving its stated aim.

Organisational requirements: Article 1(2). The organisational requirements in the UCITS Directive are not intended to address specific investment risks to the value of individual portfolio securities. Article 1(2), however, would require both compliance and internal audit functions to incorporate sustainability risk assessment in their control programs.

Asset managers' compliance or internal audit control programs do not cover management of security-level investment risks. Rather they address business risks such as anti-money laundering, fraud, business continuity, valuation/pricing procedures, client information security, trading errors, insider trading, and due diligence processes for the organisation as a whole. The incorporation of ESG integration into the investment process is the responsibility of the portfolio management teams. Personnel such as the Chief Investment Officer provide oversight to ensure funds are managed in accordance with their strategy and risk profile as disclosed to investors. Compliance and audit personnel ensure that the investment teams are managing their portfolios in accordance with their ESG-related disclosures and the firm's ESG policy, but they are not intended to second-guess the research and analysis of the portfolio managers.

Investment risks are addressed in due diligence, as part of an asset manager's investment process, not in an asset manager's control programs. The UCITS Directive provisions on organisational requirements therefore are not relevant to achieving the Commission's aim and should not be amended.

⁵ See UCITS Draft DAs, Recital 3 (noting that the Commission's aim is to ensure that management companies assess sustainability risks that could negatively impact the value of an assessment and that internal procedures and organisational arrangements are properly implemented and adhered to).

Senior management responsibilities: Article 1(5). We have similar feedback on the Commission’s proposed amendment to the UCITS Directive Article 9. This amendment aims to clarify that the integration of sustainability risk is part of the responsibilities of an asset manager’s senior management, by requiring senior management to institute internal control mechanisms and systematic processes that ensure appropriate consideration of ESG risks and factors.

The senior management responsibilities provision is not intended, however, to address specific investment risks to the value of individual portfolio securities. Rather, these provisions address business risks such as valuation or the risk that a fund’s approved investment strategy is not being appropriately followed. The UCITS Directive does not specify senior management’s responsibility for other security-level investment risks because integration of these material investment risks is part of the responsibilities of the investment team.

Conflicts of interest: Article 1(6). Fund managers generally have comprehensive policies and procedures around how to manage and mitigate organisational conflicts of interest. Examples of these conflicts may include outside business activities that conflict with internal firm duties or firm interest; making investments in a company that also manages money for executives; brokerage practices; gifts and entertainment; or accepting personal fees or commissions not in the usual course of firm business.

Some of these organisational risks theoretically could arise in the context of the investment process (*e.g.*, if there is a personal relationship with a company). The conflict of interest requirements in the UCITS Directive are not intended to address security-level investment risks, however, and we do not anticipate conflicts of interest arising with respect to sustainability risk to a portfolio investment.

Risk management: Article 1(8). It is important to clarify that investment management and risk management are separate functions that serve different purposes. The risk management program requirements in the UCITS Directive are required to be separate and distinct from the investment management process.⁶ Fund managers’ risk management programs are focused on strategic, operational, and financial business risks. The risk management program also covers overall fund-level risk (such as liquidity or market risk), but it is not intended to address specific investment risks to the value of individual portfolio securities. Sustainability risks often are specific to the company or sector in question and are better addressed on a case-by-case investment basis rather than by an overarching risk management process.

⁶ See Article 15 of Directive 2011/61/EU. See also Recital 53 of Commission Delegated Regulation (EU) No. 231/2013.

These types of security-level investment risks are addressed in due diligence, as part of a fund manager's investment process. Because the risk management program requirements in the UCITS Directive focuses on business risks and fund-level risks, we recommend that the Commission instead focus its amendments on the due diligence requirements.