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10 February 2017

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## Joint Consultation Paper on

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# PRIIPs with environmental or social objectives

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### Joint Consultation Paper

With regard to the request by the services of the European Commission for the Joint Committee's advice on the contents of the delegated acts to be adopted pursuant to Article 8 (4) of Regulation (EU) No 1286/2014 on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs).

Article 8 (4) – the procedures used to establish whether a PRIIP targets specific environmental or social objectives

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# Acronyms

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AIFMD	Alternative Investment Fund Managers Directive
AIFs	Alternative Investment Funds
CP	Consultation Paper
EBA	European Banking Authority
EC	European Commission
EIOPA	European Insurance and Occupational Pensions Authority
EOS	Environmental or social
ESAs	European Supervisory Authorities
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
EU	European Union
Eurosif	European association for the promotion and advancement of sustainable and responsible investment across Europe
EuSEF	European Social and Entrepreneurship Funds
EuSEF	European Social Entrepreneurship Funds
GSIA	Global Sustainable Investment Alliance
IDD	Insurance Distribution Directive
IMD	Insurance Mediation Directive
IPS	Investment policy statement
KID	Key Information Document
MiFID II	Markets in Financial Instruments Directive II
NGO	Non-governmental Organisation
POG	Product Oversight and Governance
PRIIP	Packaged Retail and Insurance-based Investment Product
RI	Socially responsible investment
UCITS	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) UTC

# 1. Responding to this Consultation

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The European Supervisory Authorities (ESAs: EBA, EIOPA and ESMA) welcome responses to the specific questions and on the draft 'Technical Advice' listed in this joint consultation paper, on the procedures used to establish whether a Packaged Retail and Insurance-based Investment Product (hereafter, PRIIP) targets specific environmental or social objectives, under Article 8 (4) of Regulation (EU) No 1286/2014.

The consultation package includes:

- The Consultation Paper
- Response form

The ESAs invite comments on any aspect of this paper. Comments are most helpful if they:

- contain a clear rationale; and
- describe any alternatives the ESAs should consider.

The ESAs also invite specific comments on Section 4 on the draft Technical Advice.

## Submission of responses

The Consultation Paper is available on the website of the Joint Committee: <https://esas-joint-committee.europa.eu/consultations/>. Comments on this consultation can be sent using the response form, to the email address [CP-17-002@eiopa.europa.eu](mailto:CP-17-002@eiopa.europa.eu) under the subject 'CP-17-002\_on\_EOS\_PRIIPs' by 23 March 2017, 18h00 CET.

Contributions not provided in the template for comments, or after the deadline will not be processed.

## Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the ESAs' rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Board of Appeal of the ESAs and the European Ombudsman.

## Data protection

Information on the protection of individuals with regard to the processing of personal data can be found under the heading 'Legal framework' of the EIOPA, and under the heading 'Legal notice' of the EBA and ESMA website (<https://eiopa.europa.eu/About-EIOPA/Legal-framework>, <http://www.eba.europa.eu/legal-notice>, <http://www.esma.europa.eu/legal-notice>).

## 2. Overview, Questions and Next Steps

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### 2.1 Overview of Consultation Paper

#### Purpose of the Consultation Paper

On 31st May 2016 the European Commission mandated the Joint Committee to provide Technical Advice specifying the details of the procedures used to establish whether a PRIIP targets specific environmental or social objectives, based on Article 8(4) of the Regulation.

Article 8 (4) of Regulation (EU) No 1286/2014 (the PRIIPs Regulation) states that:

*“4. The Commission shall be empowered to adopt delegated acts in accordance with Article 30 specifying the details of the procedures used to establish whether a PRIIP targets specific environmental or social objectives.”*

According to the mandate, where a Key Information Document (KID) states that a PRIIP targets environmental or social objectives (hereafter: EOS PRIIP), the manufacturer must be able to demonstrate to stakeholders, and in particular to the potential retail investor, in supporting documentation to the KID, the relevance of these objectives for the whole value chain of the investment process.

The European Commission therefore requests the ESAs to consider whether measures are required to ensure PRIIPs manufacturers have appropriate governance systems in place to ensure that disclosed EOS objectives are met. The ESAs should examine the product governance requirements and validation procedures laid down in existing EU legislation, whether they are also adequate for this purpose, and what extra measures might be considered if shortfalls are identified in the current legal framework.

This Consultation Paper provides stakeholders with an opportunity to comment on the draft Technical Advice developed by the ESAs on the procedures to be used to establish whether a PRIIP targets specific environmental or social objectives, pursuant to the Regulation (EU) No 1286/2014.

#### Structure of the Consultation Paper

After a short introduction to the overall aim of the PRIIPs KID Regulation and some background to the European Commission’s mandate to the ESAs on EOS PRIIPs, an overview of the current status of the market for EOS PRIIPs in selected EU Member States is provided, with reference to the larger segment of ‘Socially Responsible Investments’ (RI). Existing approaches and markets for qualification of EOS and RI products are surveyed, as well as associated investment strategies. Following an overview of consumer protection challenges arising in view of the issues outlined in the mandate of the European Commission, a gap analysis looks at existing governance and other relevant regulatory requirements, to assess the sufficiency and consistency of these.

In Section 4, the minimal standards – building on and reflecting the existing measures set out in the gap analysis – for a governance approach to EOS PRIIPs are developed, starting from the

perspective of the retail investor who wishes to generate a socially/environmentally desired impact.

Manufacturers claiming a PRIIP to be targeting EOS objectives should establish a well-founded and robust investment strategy, that is consistent with the EOS objectives claimed in the KID of the EOS PRIIP.

Retail investors must be enabled to assess the credibility of EOS objectives for a given EOS PRIIP. This assessment must be based on reliable information for the particular objective that is sought to be achieved, how it is measured by the manufacturer and how compliance with the objective is ensured during the investment period.

The manufacturer must establish processes which may vary across PRIIPs consistent with the objectives they disclose.

The KID should at least contain an outline of the EOS objectives, together with a link to more detailed elaboration on all of the relevant steps of the investment lifecycle. This information needs to be easily accessible by the retail investor and should be provided so that the retail investor can rely on the information as a commitment by the PRIIP manufacturer. More detailed information should supplement the contents of the KID. New documents are not needed for this, for instance where a prospectus is available, this may be the appropriate means of transmitting the more detailed information to the retail investor. The PRIIP manufacturer must ensure appropriate monitoring, governance and control procedures are in place to cater for compliance to the statements made to the retail investor, of sufficient specificity to reflect the objectives and strategy of the particular EOS PRIIP.

The ESAs have concluded that existing governance and other requirements include the relevant principles for achieving these outcomes, including the necessity of information to be fair clear and not misleading, and the general obligations on product oversight and governance. The ESAs however note that the European Commission may consider articulating these principles and obligations in the context of EOS PRIIPs through specific measures, to provide greater certainty for retail investors and for PRIIP manufacturers in the context of EOS PRIIPs.

Respondents to the Consultation Paper (CP) are asked for their view on appropriateness of the given measures.

A preliminary impact assessment is given in Section 5 for the set of rules proposed in Section 4.

## 2.2 Specific questions to stakeholders

There are a number of questions within the draft technical advice where the ESAs are seeking specific feedback from stakeholders, as follows. All references are to the draft technical advice within this CP.

- Question 1: Do you see the need for additional policy requirements consistent with the mandate, going beyond what is suggested in Section 4?
- Question 2: What are in your view the constraints of the measures proposed in the technical advice with respect to effective governance and supervision?

- Question 3: Do you deem the principle-based approach in Section 4 for addressing EOS specific product governance and oversight requirements for PRIIPs appropriate?
- Question 4: Do you have any suggestions beyond the measures outlined here?

## 2.3 Next steps

The ESAs will consider the feedback received on this consultation paper.

The Technical Advice required by Article 8(4) of the PRIIP Regulation will be submitted for acceptance by the European Commission by 30 April 2017. The ESAs shall also publish final feedback on the consultation at this time.

As of the 1st January 2018 the PRIIP Regulation will apply, and PRIIPs manufacturers will have to indicate whether or not a PRIIP targets EOS objectives.

# 3. Discussion of possible elements of the Technical Advice to the European Commission on PRIIPs with Environmental or Social Objectives

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## 3.1 Background: PRIIPs Regulation and mandate on Technical Advice

Investors, during the last decade and in some cases over a longer period, have started to pay increasing attention to externalities of investment. As a reaction to this increased awareness of possible negative effects of a certain investment, socially desired impacts or environmental outcomes were taken into account during the development of, and were explicitly used for marketing new types of products. In response, a growing number of financial products appeared in the market which claim to pursue a wide variety of objectives in addition to the traditional ones of providing monetary returns to investors. Such novel – sometimes high-minded – objectives are currently examined and addressed at the political and regulatory level under a variety of designations and with different scopes (e.g. ‘Environmental, Social and Governance [ESG]’ issues that create long-term value; ‘Socially Responsible Investments [RI]’, additionally taking into account for an investment at which degree it fosters certain socially desired outcomes; see below for an outline of the current market situation).

The focus of the European Commission’s mandate to the ESAs is investments targeted at retail investors (that is, PRIIPs) that set out EOS objectives in their KID. These overlap to a certain extent with these existing developments.

The aim set out by the European Commission is for a common approach to be set at the European level to frame the processes by which PRIIPs manufacturers will ensure that EOS objectives, which are put forward in the KID of the PRIIPs, are actually met. To that end, the ESAs through the Joint Committee have been mandated to draft advice on potential delegated acts which PRIIPs manufacturers must follow when they offer such PRIIPs.

The Joint Committee is specifically asked to consider the product governance procedures PRIIPs manufacturers should put in place in respect of EOS objectives. The mandate also refers to the processes, systems and controls required for ensuring internal product governance procedures are followed and validated.

The European Commission highlights three areas that it expects the technical advice to address:

- **The setting out in a clear fashion of the scope of the EOS objectives.**  
The establishment of an investment policy statement (IPS) specifying in detail the scope of the EOS objectives that are being targeted as well as the constraints, for example, in

terms of risk/return, time horizon, liquidity, the retail investor will have to accept to meet these objectives;

- **The determination of a clear investment policy to deliver on the defined objectives.**

The development of an investment strategy which carries the IPS into practice with instructions on how the PRIIPs manufacturer must fulfil the mandate. The investment strategy should also include the methods by which retail investors' money is allocated across asset classes and specific assets filtered in light of the aims set out in the IPS.

- **The monitoring of the investment policy on an ongoing basis.**

The development and operation of processes, systems and controls to ensure that the investment strategy is properly implemented and adhered to over time. This could include regular reviews to ensure assets remain in line with the investment strategy, periodic reviews and reporting lines to responsible senior management.

Finally, the mandate also specifies that the advice should not address labelling or substantive product regulation. The advice that the Joint Committee will address to the Commission will therefore not aim at qualifying whether an objective can be deemed EOS.<sup>1</sup>

The European Commission has requested the Joint Committee to provide technical advice by the 30 April 2017.

## 3.2 Introduction / Motivation

### Market trends: some countries profiles

The mandate seeks to avoid a normative labelling approach, not only because of the European Commission's mandate. This approach is also followed as a reflection of the fact that there are currently no widely accepted definitions of 'environmental or social investments' available in the EU legal framework for financial markets. Thus, specific data in this area is not readily available. That being said, an area that appears to have at least some of the objectives in common with the investments referred to in Art. 8 (4) of the PRIIPs Regulation is the one of 'socially responsible investment' (RI)<sup>2</sup>. It can be concluded from RI data, that sustainable and responsible investment strategies are in aggregate continuing to grow, at a faster rate than the broader European asset management market.

According to Eurosif<sup>3</sup> and GSIA<sup>4</sup> research work, investors view RI as an opportunity to both reduce their portfolio risks and have an impact on society. Institutional investors promote their social

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<sup>1</sup> Recital 19 of the PRIIPs Regulation anticipates that in its review of this Regulation the Commission could consider further developments relating to EOS investment products.

<sup>2</sup> The abbreviation coincides with the one of the 'Single Risk Indicator', which is used in the PRIIPs KID. As the latter is not subject of this CP, nor of the final Technical Advice to the European Commission, every instance of 'SRI' throughout the CP refers to 'Socially Responsible Investments', if not stated otherwise.

<sup>3</sup> The European Sustainable Investment Forum (Eurosif) is one of the leading European membership association whose mission is to develop sustainability through European financial markets. Eurosif Member Affiliates include a range of organisations covering the value chain of the sustainable investment industry, from institutional investors, asset managers to financial services providers, ESG analysis firms, academic institutes and NGOs, together representing assets totaling about € 1 trillion.

responsibility and are sensitive to reputation risk. Retail clients hope to have an impact on society and align their investments with their values.

Some public authorities have been considering developing labels to make it easier to understand the RI offering, particularly for retail investors. Private labels already exist in Luxembourg (LuxFlag created in 2006/RI label in 2014) and in France (Novethic label created in 2009). In France, on the 28<sup>th</sup> September 2015, the Minister for Finance and Public Accounts launched an RI label supported by the public authorities.

The 2016 Eurosif report provides some interesting insight on several European country profiles vis-à-vis RI. From this report it is possible to draw the following examples of countries where significant RI market developments have been noticed recently across the banking, asset management and insurance sectors<sup>5</sup>.

As of today, France remains among the most developed RI markets in Europe with around 50 Asset Managers which market RI funds<sup>6</sup>. The French RI market has grown significantly over the last two years resulting in an increase of 61.7% in Assets under Management<sup>7</sup>. The growth for the 2013-2015 period has outpaced the 2011-2013 growth of 47.2%.

In Germany, all three pillars of the banking industry (publically and privately owned and cooperative banks) are important with respect to the RI market. Several private banks, including the market leaders, offer a broad variety of RI products. A few other RI specialised fund management companies are less important in quantitative terms but vitally important with regard to setting standards and best practices.

Institutional investors continue to lead the Italian RI market, mainly driven by a few large insurance companies. The retail side has also witnessed interesting growth as several Italian asset managers recently decided to launch RI products in order to meet the increased awareness level of private investors. Over the last two years, the retail sustainable funds distributed by Italian asset managers have increased by 26%.

Assets under management in RI in Spain reached nearly 170,000 million Euros in 2016, signifying a growth rate of 16.3% over the last two years. This means 47% of international investment companies (IICs) and pensions uses some RI criteria in their investments. The main strategy is still the simple exclusion (72%), followed by screening by norms. Other more sophisticated strategies such as thematic investment are growing fast, though still small. Another significant feature of the Spanish market is that it is still mainly institutional, with only 3% of the market share invested directly by retail investors. collective investment schemes and pensions are the most popular

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<sup>4</sup> The Global Sustainable Investment Alliance (GSIA) is an international collaboration of membership-based sustainable investment organizations. Its mission is to deepen the impact and visibility of sustainable investment organizations at the global level.

<sup>5</sup> According to the Eurosif 2016 report, the asset allocation distribution registered a significant decrease in equities, now at 30% of the total RI assets down from last year's 50% and back to the 2011 and 2009 levels. There was a sharp increase in bonds, which was worth noting at 64% from the 40% registered in December 2013.

<sup>6</sup> 70% of which have been awarded the Novethic label.

<sup>7</sup> According to Novethic ("2015 figures on Responsible Investment in France"), total AuM under responsible investment RI approaches have risen to €746 billion in France.

instruments, though some alternative instruments such as private equity or social bonds are emerging.<sup>8</sup>

The UK RI market is well-diversified and flourishing. Although the impact and social investment markets are still small compared to the whole investment field, they are growing steadily. In a recent report, Big Society Capital estimated the value of social investment to be £1.5 billion at the end of 2015, while the wider impact investment market is believed to be worth approximately £73 billion.

### **Intentions of manufacturers and potential investors**

In recent years, RI has grown substantially in Europe. Several initiatives have been implemented in several countries. On a broad scale, Eurosif, PRI<sup>9</sup> and GSIA initiatives have made significant contribution to the development of RI issues. According to Eurosif, 'Sustainable and Responsible Investment' is a long-term oriented investment approach, which integrates ESG factors in the research, analyses and selection process of securities within an investment portfolio. It combines analysis and engagement with an evaluation of ESG factors in order to better capture long term returns for investors, and to benefit society by influencing the behavior of companies.

Investor's intentions with RI vary across different groups:

- Institutional investors promote their social responsibility and are sensitive to reputation risk.
- Retail clients hope to have an impact on society and align their investments with their values.

Both groups may choose to diversify their risk by gradually abandoning classic investments, which have not yet been proven as questionable and/or less safe in the light of the development of the public debate and consequential change in legislation.

Both Socially Responsible Investments and – as a group of financial instruments with overlapping features – EOS PRIIPs have in common the aim of generating returns whilst having objectives that add a non-financial dimension – including new opportunities and associated risks – to the overall outcome. The balance between the classical return-based targets and the so-called 'non-financial' objectives varies across individual types of EOS PRIIPs, and RIs as well. In general, the primary objectives of socially responsible investment are threefold:

- Invest with a certain philosophy and in keeping with certain values;
- Invest while taking into account the risks and opportunities identified in the non-financial analysis of issuers;

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<sup>8</sup> <http://www.spainsif.es/contenidos/el-patrimonio-de-los-fondos-isr-se-acerca-los-170000> (Spanish press release; as of 23 Nov 2016).

<sup>9</sup> Principle for Responsible Investments is one of the world's leading proponent of responsible investment. It works to understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. <https://www.unpri.org/about>

- Invest to make a positive impact on social, environmental and governance issues.

### 3.3 Possible approaches to governance requirements

#### Different kinds of strategies

The following strategies have been observed in the areas of funds today that are members of the respective industry initiatives. Subsets of these and variants thereof could be easily applied in analogy to PRIIPs based on bonds, structured finance and virtually all types of PRIIPs marketed today<sup>10</sup>. The framework of possible regulatory measures set out in the technical advice in section 4 reflects this diversity of possible EOS PRIIPs and the issues raised in ensuring retail investors are well informed about these EOS PRIIPs.

According to GSIA and Eurosif research work, seven major categories of RI strategies can be identified. The major categories used to classify the population of RI products are non-disjoint sets (i.e. RI investment management can be characterised by the adoption of one or more standard approaches). The labeling of these categories differs from one institution to the other. Hence, we will stay consistent with the Eurosif approach in this paragraph.

*Best-in-class* is an approach that aims at selecting the issuers which have the best ESG score in a particular sector. It is one of the positive approaches as opposed to the approaches that rely on exclusions.

*Sustainability Themed* focuses on sustainable investment themes, such as renewable energy or water management. This strategy allows the investor to focus on a specific area of sustainable developments.

*Norms-based screening* have been developed with the idea that, even if companies do not face the same legal requirements regarding environmental, social or governance issues between one country and another, they must be in a position to comply with a certain number of fundamental international norms<sup>11</sup> in order to meet the requirements of responsible investors, regardless of the business involved or the country in which they operate. Unlike positive approaches, which are usually based on comparisons between companies in the same sector (Best-in-class), norm-based exclusion therefore aims to be more “universal” by establishing minimum ESG norms.

*ESG Integration* is the explicit inclusion of ESG factors by portfolio managers into traditional financial analysis. This is based on the conviction that a company value should be sustainable in the long-term and hence financial valuation should factor ESG criteria. The degree of integration can vary. A manager can make the ESG analysis available to general analysts and fund managers without standardising the procedure. An ESG analysis can also be more systematically included in the investment process.

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<sup>10</sup> This is stated with respect to the type of underlying(s) of the respective PRIIP, *not for each and every PRIIP*. Clearly, *reasonable* EOS objectives need to be pursued as the most important in the set of requirements given below.

<sup>11</sup> E.g. the Eurosif Transparency code provides for the following overarching principle : signatories should be open and honest, and disclose accurate, adequate and timely information to enable stakeholders, in particular retail investors, to understand the policies and practices of a given SRI fund”.

*Engagement and voting* aims to promote corporate sustainable RI practices. Investors will exert their fiduciary duty to beneficiaries by actively encouraging a target company's management to work towards improving governance and contributing to sustainable development. This implies setting up an open dialogue with the target company's management and can for example be performed by voting at the annual shareholders' meeting or by submitting resolutions.

*Exclusions* is a negative approach where investors decide to exclude companies that fail to comply with international standards or conventions (e.g. violations of human rights, environmental standards, etc.) or with internally set ESG criteria.

*Impact investing* involves making targeted investments (in particular in unlisted companies) to solve social or environmental problems. The capital invested can be directed to underserved individuals. The same RI approach can result in the construction of vastly dissimilar portfolios/products. Conversely, broad similarities can sometimes be found between a portfolio managed to an RI standard and a traditional non-RI portfolio, and questions may be raised about the differentiating impact of certain RI management practices.

### **Market trends: management methods and strategies**

Regarding the general market trends of the management methods and strategies, the 2014 Global sustainable investment review, published by the Global Sustainable Investment Alliance<sup>12</sup>, describes the wide range of RI management methods used around the world. The regions of the world with the sharpest growth in RI assets are the United States, Canada and Europe. These regions represent 99% of responsibly managed assets.

Regarding the different strategies, the most common practice internationally is negative screening or exclusion, particularly in Northern Europe. This is followed by RI integration, which prevails in the United States, Australia, New Zealand and Asia. In third place is engagement, which is particularly popular in Canada.

A Eurosif report published on February 8, 2015<sup>13</sup> paints a picture of the European RI market. The primary RI strategies implemented in Europe are exclusion, RI integration and shareholder engagement.

Norms-based exclusions continue to be widely used in Northern Europe. They relate in part to the steps taken at the national level on cluster munitions and anti-personnel landmines, but also have a broader scope. RI integration is very widespread in the United Kingdom, the Netherlands and France, whether in its broadest form (RI research made available to general analysts/managers) or most absolute forms (systematic RI integration and/or constraint-based RI integration).

If only systematic RI integration and constraint-based RI integration are considered, the leading countries in Europe are the United Kingdom, France and the Netherlands. With European legislative measures such as the 'Shareholder Rights' directive, engagement and the exercise of voting rights are expected to gain ground. The rising use of these strategies demonstrates the

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<sup>12</sup> Global sustainable investment review, GSIA,

[http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA\\_Review\\_download.pdf](http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf)

<sup>13</sup> European SRI Study 2014 (8 February 2015) - [www.eurosif.org](http://www.eurosif.org)

shift in investment management behaviour, particularly in markets such as Italy (193% growth between 2011 and 2013), Germany (up 48%) and Belgium (up 94%) where engagement had not been as widely used in the past. Leaders in engagement are the United Kingdom, the Netherlands and Norway.

Touching on the other types of RI strategies, the Eurosif report highlights the widespread use of the best-in-class approach in France and its rapid ascension in Norway and the Netherlands. Themed investing also soared in France with a compound annual growth rate of 166% between 2011 and 2013.

The table below is exhibited in the Eurosif 2016 Report (page 57). It presents a total sum of each individual strategy per country and the total of all strategies grouped together without overlap and displays the AuM of RI investments<sup>14</sup>.

Countries	Best-in-Class	Sustainability Themed	Norms-based Screening	ESG Integration	Engagement and Voting	Exclusions (All)	Impact Investing	All strategies combined
Austria	8 153	271	7 920	1 363	3 791	42 736	323	52 184
Belgium	17 542	275	50 426	90 384	45 645	253 946	340	315 900
Denmark	15	5 232	261 776	63 149	227 651	305 109	31 500	118 376
Finland	439	656	111 868	44 210	46 711	138 422	444	67 978
France	321 984	43 065	2 650 582	338 170	38 500	666 215	1 138	3 121 081
Germany	21 088	8 157	15 379	27 733	31 880	1 803 473	4 763	1 786 398
Italy	4 058	2 064	565 607	45 008	43 303	569 728	2 927	616 155
Netherlands	56 645	37 114	936 399	440 695	726 314	1 123 133	40 791	991 427
Poland	2 717	3 762	2 769	-	-	2 769	34	5 998
Spain	2 535	300	24 003	8 283	10 455	123 516	267	95 334
Sweden	10 967	2 315	378 189	358 520	444 719	714 638	1 421	791 739
Switzerland	38 866	21 017	75 051	92 876	77 345	2 536 014	9 818	1 527 582
UK	8 368	21 022	7 806	1 135 955	2 573 731	1 870 896	4 564	1 555 328
<b>Europe (13) in € million</b>	<b>493 375</b>	<b>145 249</b>	<b>5 087 774</b>	<b>2 646 346</b>	<b>4 270 045</b>	<b>10 150 595</b>	<b>98 329</b>	<b>11 045 479</b>

## Challenges for investor protection

For all PRIIPs, and hence also for EOS PRIIPs, it is important that PRIIPs manufacturers are transparent about their products, strategies and constraints. This transparency can also translate into/ be enabled by the disclosures provided in the KID and additional detailed disclosures (which are referred to in the Mandate as the investment policy statement (IPS)). For successfully establishing a EOS market and to foster the achievement of socially desired objectives, retail investors must be enabled to confide in manufacturer's compliance with stated objectives, strategies and constraints.

The PRIIPs KID is a document in which the manufacturer states its commitment about the product's EOS objectives. The PRIIP KID must therefore specify key elements of the RI process. In the PRIIP KID itself, space limitations mean a full description of the link between the EOS objectives, the product's investment strategy and, where applicable, the asset selection criteria may not be feasible. Bearing this in mind, information that explains the key products' EOS aspects should be included in summary form in the PRIIP KID and be detailed more thoroughly in the IPS (likely to be covered in practice in the product's or fund prospectus, where this is available, or for

<sup>14</sup> Available under <http://www.eurosif.org/>.

example on the manufacturer’s website over the lifetime of the product). Information provided should be coherent with all other relevant documents.

Much of the challenge of defining the concept of EOS lies in the degree of subjectivity incorporated in the investment strategy process. Insofar as retail investors are likely to have neither prior knowledge of the scope of EOS nor a technical understanding of the different possible approaches, the information should enable them to place any EOS product in the context of a universe made up of several major generic approaches.

The wide variety of EOS practices only presents a real opportunity to retail investors if the information provided to them is sufficient to form an opinion about whether the products meet their expectations. This aspect is also important for any financial intermediaries which should need to have an understanding about the EOS strategy of the products they are recommending or offering. Limited comprehension of EOS strategies and objectives could lead to potential cases of mis-selling.

At the EU level, there exists already a number of legal acts in the financial area, which address purposes that strongly overlap with EOS. One case, where the whole legislative act aims at establishing a new product category<sup>15</sup>, is the Regulation on ‘European Social Entrepreneurship Funds’ (‘EuSEF’):

<b>Investment universe of EuSEFs</b>	
<p><b>Regulation 346/2013 (EuSEF)</b></p> <p>Art. 3.1(b), Art. 3.1(e), Art. 3.1(d) and Art. 3.1(g) + (h)</p>	<p>The provisions contained in Regulation 346/2013 fit PRIIPs whose underlying are EuSEFs or portfolios under management, but also PRIIPs other than funds such as structured bonds. In that case the notion of <i>qualifying portfolio undertaking</i> provides useful elements.</p> <p>It is important to keep in mind that according to Articles 2 and 26 of Regulation 346/2013 delegated acts are expected on the types of goods and services that embody a social objective.</p> <p>The question arises as to whether a EuSEF should be considered to have met any and all expectations on processes as might be required under the PRIIPs Regulation.</p>

### 3.4 Gap analysis

The mandate of the European Commission (see section 3.1 for background information) seeks technical advice that builds on existing governance rules, that have been laid down in the financial market EU legal framework. The focus, as outlined above, is on measures on transparency related to the investment strategy, governance measures related to the implementation of that

<sup>15</sup> In contrast, e.g. the Directive 2016/2341/EU on ‘the activities and supervision of Institutions for Occupational Retirement Provision’ (the ‘IORP II Directive’), includes, *among others*, new requirements on IORPs to take into account ESG considerations in the IORP’s governance and risk management systems, as well as in the preparation of the Statement of Investment Policy Principles (SIPP). IORPs must also provide information to prospective members on how ESG factors are considered in the scheme’s investment approach.

investment strategy, and monitoring measures related to ongoing assessments. Measures of these kinds are generally already in place across the different elements of the EU legal framework though they may not be specifically articulated so as to refer to EOS investments, even while EOS investments fall within their scope. However it is important to assess any potential gaps or areas where more specific or explicit clarifications for EOS investments might be needed.

The focus of the Gap Analysis – as well as of the Draft Technical Advice – has been on product oversight and governance rules, following the mandate of the European Commission<sup>16</sup>. This covers in the ESAs' view the key requirements for ensuring a sound and effective market for EOS PRIIPs and enabling supervisors to carry out their duties.

As part of this, however, measures are discussed related to the transparency, where the mandate of the European Commission indicates the importance of ensuring appropriate information is disclosed towards the retail investor. Common approaches to this could also provide supplementary insight to the supervisor on the assessment of the eligibility of associated governance processes.

In this regard, some (ex ante and ex-post) transparency elements are foreseen in the Draft Technical Advice, including through an 'investment policy statement' and with regard to the regular review of the EOS PRIIP manufacturer on compliance with the EOS objectives and the associated investment strategy during the lifetime of the product. It is considered that these transparency measures are readily covered under existing sectoral measures related to transparency (e.g. under Solvency II, IDD, MiFID II, the Prospectus Directive, the UCITS Directive and the AIFMD).

The Draft Technical Advice sets out common expectations in regards to such transparency, in view of ensuring sufficient clarity on expectations towards the manufacturers of EOS PRIIPs.

### **Product Governance requirements – Comparison Table**

The relevant Product Governance rules which apply for the different sectors are outlined in the comparison table below. It should be noted that the regulatory requirements on Product Governance are in many aspects a relatively new regulatory concept which has lately been recently introduced in the context of the revision of the Markets of Financial Instruments Directive (MiFID) and the revision of the Insurance Mediation Directive (IMD). In both legislative procedures, MiFID II and Insurance Distribution Directive (IDD), European Legislators have introduced specific requirements on Product Oversight and Governance (POG) applicable to manufacturers of products and distributors of financial instruments and insurance products. In both instances, the general requirements which have been introduced require further specification through delegated acts. In April 2016, the European Commission adopted the Delegated Directive for MiFID II which follows ESMA's Technical Advice concerning MiFID II. EIOPA is in the process of finalising its Technical Advice for IDD to be submitted to the European Commission in February 2017. The Product Governance requirements will have to be applied by

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<sup>16</sup> See subsection 3.1 on page 8 for detailed information on the content of the European Commission mandate on EOS PRIIPs to the ESAs.

market participants from the application date of the Level 1 provisions. The application date of MiFID II is 3 January 2018 and the application date of IDD is 23 February 2018.

The comparison table below also indicates any gaps and differences between the envisaged Level 2 acts as well as between the different financial sectors. While all financial instruments, including units in collective investment undertakings, manufactured and/or distributed by MiFID entities are subject to MiFID product governance rules, pure UCITS or AIF manufacturers are not in scope. ESMA has already highlighted the differences among UCITS, AIFMD and MiFID II frameworks in the area of product governance in its Technical Advice of 19 December 2014 to the European Commission (EC) and its (April 2016) Response to the EC Green Paper on retail financial services.

As outlined above, EIOPA is currently in the course of finalising its Technical Advice to the European Commission on possible delegated acts under IDD. Furthermore, EIOPA already published Preparatory Guidelines on Product Governance and Oversight in April 2016 in order to support market participants in their efforts to implement the new requirements on Product Oversight and Governance under IDD (“Prep POG Guidelines”). ESMA has also published a Consultation Paper on product governance guidelines under MiFID II regarding the target market assessment by manufacturers and distributors of financial products<sup>17</sup>.

<b>Product Governance rules</b>		
<b>Topic</b>	<b>Type of underlying of the EOS PRIIP</b>	<b>Rules</b>
<b>Responsibility of the process: the management body</b>	Financial instruments/structured deposits	MiFID II article 9.3
	Insurance products	Solvency II article 40, Draft Technical Advice of EIOPA as well as Guideline 3 and Guideline 15 of the Prep POG Guidelines
	UCITS	MiFID II article 9.3 limited to the investment services <sup>18</sup>
	AIFs	MiFID II article 9.3 limited to the investment services <sup>18</sup>
<b>Establishment of a policy/process for the approval of the products</b>	Financial instruments/structured deposits	MiFID II articles 9.3 and 16.3, MiFID II Delegated Directive (in particular Article 9)
	Insurance products	IDD article 25, Draft Technical Advice of EIOPA, as well as Guideline 1 and Guideline 13 of the

<sup>17</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-consults-product-governance-guidelines-safeguard-investors>

<sup>18</sup> No exact equivalence can be found with regard to product oversight and governance rules under Directive 2014/65/EU (MiFID II) and the rules applicable to UCITS or AIF managers under Directives 2009/65/EC (the ‘UCITS Directive’), 2011/61/EU (‘AIFMD’) and their respective Level 2 acts. ESMA already highlighted the differences in its Technical Advice of 19 December 2014 to the European Commission as well in its Response response to the Green Paper on Retail Financial Services. Please see also paragraph 4 of section 4.

		Prep POG Guideline
	UCITS	MiFID II articles 9.3 and 16.3 limited to the investment services <sup>18</sup>
	AIFs	MiFID II articles 9.3 and 16.3 limited to the investment services <sup>18</sup>
<b>Identification of the target market</b>	Financial instruments	MiFID II article 24.2 and Delegated Directive articles 9 and 10
	Insurance products	IDD article 25, Draft Technical Advice of EIOPA and Guidelines 5 and 18 of the Prep POG Guideline
	UCITS	MiFID II article 24.2 and Delegated Directive articles 9 and 10 limited to the investment services <sup>18</sup>
	AIFs	MiFID II article 24.2 and Delegated Directive articles 9 and 10 limited to the investment services <sup>18</sup>
<b>General governance and organizational requirements</b>		
<b>General governance requirements</b>	Financial instruments	MiFID II, article 9
	Insurance products	Solvency article 41
	UCITS	Directive 2010/43 article 4 <sup>18</sup>
	AIFs	Directive 2011/61 article 18 <sup>18</sup>
<b>Establishment of an investment policy statement for EOS PRIIPs</b>		
<p>Product Governance rules require that manufacturers establish a policy as to the product oversight and governance arrangements which have been established for the product approval and to ensure that the products are consistent with the identified target market to whom products and services will be offered or provided.</p> <p>In this context, manufacturers shall also identify the target market of the EOS PRIIPs, possibly taking into account the EOS objectives, the risk/return profile, the time horizon and the financial situation of the target market.</p> <p>The above mentioned obligations do not apply to asset management companies of UCITS and AIFs unless they are authorised to offer investment services.</p>		
<b>Development of an investment strategy</b>		
<p>The development of an investment strategy for EOS PRIIPs should be always required (and not only where the underlying of the PRIIP is a portfolio under management, typically a fund or a portfolio).</p> <p>In this respect it should be recalled the duty of the managers of EuSEF to apply a high level of due diligence in the selection and ongoing monitoring of investments in qualifying portfolio undertakings (Article 7.d Regulation 346/2013).</p> <p>Moreover, managers of UCITS are required to establish written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf</p>		

of the fund are carried out in compliance with the objectives, investment strategy and risk limits of the UCITS (Article 23 Directive 43/2010).

Managers of AIFs shall at least (article 15 Directive 2011/61):

(a) implement an appropriate, documented and regularly updated due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;

(b) ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures;

(c) ensure that the risk profile of the AIF shall correspond to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the AIF rules or instruments of incorporation, prospectus and offering documents.

Moreover, AIF managers shall apply a high standard of diligence in the selection and ongoing monitoring of investments. AIFMs shall establish, implement and apply written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, the investment strategy and, where applicable, the risk limits of the AIF (article 18 Regulation 231/2013).

With respect to the service of portfolio management it should be recalled that the management body shall monitor and periodically assess the adequacy and the implementation of the firm's strategic objectives in the provision of investment services and activities and ancillary services, the effectiveness of the investment firm's governance arrangements and the adequacy of the policies relating to the provision of services to clients and take appropriate steps to address any deficiencies (Article 9.3 MiFID II) .

When engaging in investment activity, insurance undertakings have to ensure that their obligations under the insurance contracts can be fulfilled at all times by carefully choosing the type, scope and quality of the coverage assets. The demands placed on the investment activities of insurers are therefore high. In order to ensure that the obligations under the insurance contracts can be met at all times, insurers must allocate sufficient assets to the guarantee assets. The guarantee assets, which are monitored by a trustee are subject to special regulations that are aimed at providing policyholders with additional security regarding the undertakings' ability to fulfil their obligations under the insurance contracts. Since Solvency II was implemented on 1 January 2016, investments of insurance undertakings have been governed by differing sets of rules. When making investments, undertakings subject to Solvency II are required to comply with the "prudent person principle", for which there are a number of qualitative requirements. Undertakings must prepare an internal schedule of investments, which ensures the security, quality, liquidity and profitability of the investment as a whole.

**Development and operation of processes, systems and controls to ensure that the investment strategy is properly implemented**

See remarks in the previous section ("Development of an investment strategy") with respect to requirements for PRIIPs in general in terms of IPS compliance.

As a general governance requirement, Insurance undertakings should have in place an effective system of governance which provides for sound and prudent management of the business (Article 41 Solvency II). Moreover, insurance undertakings should have in place an effective risk-management system (Article 44 Solvency II).

## 4. Draft Technical Advice

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Before discussing the technical findings derived from the market overview and the Gap Analysis above, two general points should be highlighted:

- Firstly, the draft technical advice does not intend to create an additional disclosure document for products EOS PRIIPs. Manufacturer's of these products should rather ensure existing product disclosure documents, as obligated under current legal provisions, include the information set out below.
- Secondly, the ESAs are of the view, that existing product oversight and governance (POG) principles for PRIIPs in general<sup>19</sup> are sufficient for the purposes of sound regulation of EOS PRIIPs. What is necessary for these existing rules to achieve the desired outcome of credible product information as a basis for informed retail investor decisions in a flourishing market for EOS PRIIPs, is the appropriate interpretation and application of these rules in terms of the – additional – dimension of EOS objectives.

Against this background, and in order to avoid any doubt or uncertainty on what is expected, the appropriate interpretation and application of the existing framework of POG rules could be safeguarded by a Delegated Act of the European Commission, that assists EOS PRIIP manufacturers. Such Delegated Act should take into account the following considerations:

1. A mutual relation is established by the PRIIPs Regulation<sup>20</sup> between a EOS PRIIP's detailed investment objectives (as set out in an IPS) and the statement of EOS objectives in the KID of that PRIIP.
2. Where the manufacturer sets out in disclosures other than the KID or marketing information statements on social and/or environmental investment objectives, corresponding elements in the PRIIPs KID section 'What is this product' are mandatory according to Article 8, para 3 (ii) of the PRIIPs Regulation.
3. If EOS objectives of a PRIIP are presented in the KID, this should oblige the manufacturer to set these out in more detail in a corresponding IPS. The manufacturer should be obliged to demonstrate that the EOS objectives form an integral part of the overall investment strategy and philosophy of the PRIIP. The EOS objectives must not exist as an unrelated appendix to these. The objectives should be expressed with sufficient granularity and in an illustrative, accessible and straightforward manner.

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<sup>19</sup> See the Gap Analysis under section 3.4 for an outline of the POG rules in the applicable Level 1 legislation.

<sup>20</sup> Recital 14 of Regulation (EU) 1286/2014 in conjunction with recital 4 of the ESAs' Final draft regulatory technical standards with regard to presentation, content, review and provision of the key information document, including the methodologies underpinning the risk, reward and costs information (to be found at [https://eiopa.europa.eu/Publications/Technical%20Standards/JC%202016%2021%20\(Final%20draft%20RTS%20PRIIPs%20KID%20report\).pdf](https://eiopa.europa.eu/Publications/Technical%20Standards/JC%202016%2021%20(Final%20draft%20RTS%20PRIIPs%20KID%20report).pdf)).

### **Technical Advice 1: Key Information Document and Investment Policy Statement**

*There is a mutual/close relationship between the EOS objectives stated in the KID of a PRIIP and the investment objectives as set out in an investment policy statement (IPS). The IPS shall however contain a more granular and specific description of the investment process than what is currently envisaged under the 'What is this product?' section in the KID.*

4. In light of the Gap Analysis and the highlighted differences between the MiFID and UCITS/AIFMD product oversight and governance (POG) rules, future delegated acts should clarify that all manufacturers of EOS PRIIPs should comply with the respective MiFID II or IDD product governance rules . This is to ensure sound and effective governance requirements for the manufacturing of all EOS PRIIPs<sup>21</sup>.

### **Technical Advice 2: Application of Product Governance Rules**

*All manufacturers of EOS PRIIPs shall comply with the MiFID II or IDD product governance rules, depending on the product being a financial instrument, structured deposit or an insurance-based investment product.*

5. All PRIIPs that claim to pursue EOS objectives have to put in place appropriate product governance procedures with the aim of ensuring that the stated investment objectives of a particular PRIIP are adhered to before the investment into this PRIIP is made by a retail investor, and during the lifetime of the PRIIP.
6. Appropriate governance procedures help to ensure that a PRIIP with social and/or environmental objectives 'does what it is supposed to do', thereby preventing the setting of vague 'green' or 'social' objectives that have little substance or significance in respect of the investments made by the PRIIP and the manner in which these investments are made.

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<sup>21</sup> See footnote **Error! Bookmark not defined.** for differences in the product oversight and governance framework for UCITS/AIF manufacturers, highlighted by ESMA. It should be noted, that the following specific technical advice in the blue box should encourage the European Commission to explicitly state in a future Delegated Act, that all EOS PRIIP manufacturers, including those which have UCITS or AIFs as underlyings shall be subject to the product governance rules of MiFID II or respectively IDD.

### **Technical Advice 3: Adherence to Investment Objectives**

*All PRIIP manufacturers that claim to pursue environmental or social (EOS) objectives shall establish, implement and maintain, in a way that is appropriate and proportionate, product governance procedures to ensure that the stated non-financial investment objectives are adhered to during the lifetime of the EOS PRIIP.*

*All PRIIP manufactures shall ensure that the money invested via the PRIIP are effectively and predominantly employed for the achievement of the stated EOS objectives. None of the funds underlying the EOS PRIIP must undermine the stated EOS objectives.*

7. The mandate of the European Commission referred to the disclosure of the PRIIP's investment objectives in a so-called 'investment policy statement' (IPS). This must be developed as part of the manufacturing process of the EOS PRIIP, thereby setting the stated objectives in relation to their intended outcomes and adhering to this stipulated goal on an on-going basis.
8. From the retail investor's perspective, candidate products qualify as EOS PRIIPs by a credible statement of the PRIIP manufacturer in relation to their investment objectives, but without including a definition of what 'EOS' means. This contrasts with products that are regulated in detail on what they can or cannot invest in and how this is done, for example, with the European Social and Entrepreneurship Funds (EuSEF). The statements in the KID and in the more general 'investment policy statement' shall be 'consumer facing' – using language that is understandable, clear and accessible to retail investors. However, targeting EOS objectives implies that the money invested in the PRIIP are effectively and predominantly employed for the achievement of the stated EOS objectives, eg. by investing in EOS companies. If the invested money are mainly used by the PRIIP manufacturer or the issuer for general funding purposes, it cannot be stated that the PRIIP targets EOS objectives, unless the activities of the PRIIP manufacturer or the issuer would perfectly fit in the identified EOS objectives.
9. As the credibility of the manufacturer's statement needs to be objectively established without reference to a legally defined product standard ('no labelling', see section 3.1 and 3.2), a self-contained description of a set of EOS objectives, intrinsic to a particular PRIIP, is considered an appropriate solution.
10. This approach should consist of elements similar to those of the transparency code in industry standards.<sup>22</sup> Certain requirements can be imposed on the clarity of the reasoning and its overall consistency,<sup>23</sup> that connects the statement of EOS objectives by the

<sup>22</sup> See e.g. Eurosif's transparency code under <http://www.eurosif.org/wp-content/uploads/2014/05/5.-transparency-code-english.pdf> (as of 16 Dec 2016).

<sup>23</sup> 'consistency' here refers to the requirement, that the statement must connect the EOS objectives with the actual underlying(s) of the PRIIP in a way, that can be acknowledged and understood by common sense. The reasoning must not contain irrational conclusions, weak or even false assumptions about real-world relations in terms of cause and effect or otherwise doubtful elements.

manufacturer with the product or the investment strategy and the allocation of assets behind the PRIIP. This should ensure, that the retail investor can judge for him- or herself the described objectives and assess the actual degree to which a product is capable of supporting her or his desired objectives.

#### **Technical Advice 4: Establishment of an Investment Policy Statement**

*Manufacturers of EOS PRIIPs shall establish, as part of the manufacturing process, an investment policy statement (IPS), specifying in detail the scope of the EOS objectives that are being targeted as well as the constraints. The IPS shall ensure transparency and credibility of the S&E objectives set by the manufacturer. It shall enable retail investors to match their desired EOS objectives with the investment strategy of the PRIIP on offer. The IPS shall explain in detail to retail investors, by using language that is understandable and clear, what exact impact is aimed at by the investment and why a just and equitable person would regard this as an environmental or social objective. Furthermore the IPS shall explain the investment strategy and, where applicable, its translation into the (allocation of) assets behind the EOS PRIIP. This IPS may take into account certain elements set out in industry initiatives' transparency codes.*

11. As outlined under 3.3, EOS objectives and the associated decision-making at the retail investor level may sometimes differ in nature from those of solely return-based products. Thus, ways must be explored by the manufacturer to credibly provide and present the necessary information to the retail investor, such that he is able to make an informed decision. The means of presentation shall be specific to the particular EOS objectives and product.
12. In order for the retail investor to be able to assess the credibility of the claimed EOS objectives disclosed in the KID, the manufacturer should make the more detailed IPS available and refer to the respective means of disclosure in the KID.

Publication of the IPS document in durable form, should be generally required, in order to make the necessary information available to retail investors. Where a prospectus is available, it could alternatively be regarded as an appropriate means for the manufacturer to provide transparent, comprehensive and legally binding information on the product's investment objectives and their implementation in the investment process. The prospectus shall also be referenced in the KID if it is chosen as the eligible method of IPS publication. Where no prospectus is legally required, the EOS PRIIP manufacturer shall provide the IPS in a different document, which is up to the manufacturer's choice, e.g. via the manufacturer's website.

13. According to the PRIIPs Regulation, the PRIIP manufacturer is responsible for the information in the KID to be accurate. From this legal responsibility, it can be concluded, that material deviations from the aforementioned requirements ('clear, fair, not misleading') constitutes a basis for both claims by the retail investor and supervisory sanctions. The EOS objective of a PRIIP is assumed to be a crucial element for the retail investor when deciding to buy the PRIIP. By way of presenting the EOS objective as an

integral part of the PRIIP to the retail investor by durable publication referenced in the KID, the objectives become – like every other piece of information in the KID itself – part of the investment contract for the specific product. In case the manufacturer made erroneous or misleading statements on the EOS objectives to the retail investor, this can lead to a breach of the contract, on which the retail investor can raise claims, according to national civil law.

#### **Technical Advice 5: Disclosure of Investment Policy Statement to Retail Investor**

*Retail investors should be able to access the IPS prior to their investment decision. This could be done by reference in the KID to the manufacturer’s website or, where applicable, to the prospectus, provided that the information is accessible continuously for the lifetime of the PRIIP.*

14. EOS objectives are embodied in the overall investment strategy that the manufacturer applies in order to compose the eventual EOS PRIIP. This requires a more granular and specific description of the investment process than what is currently envisaged under the ‘What is this product?’ section in the KID. The IPS receives key importance in the case of EOS PRIIPs, as information on EOS objectives in the KID can only be provided to a limited extent, due to available space for this purpose under the ‘What is this product’ section. As retail investors need more explanation on the cause-and-effect relation with regard to the EOS impact of a PRIIP, compared to e.g. PRIIPs serving a mere Return-on-Investment strategy, the IPS is the appropriate way of providing such additional information to the retail investor. Importantly, for EOS PRIIPs, the metrics for cost, investment risk and investment return set out in the KID are not sufficient, as these do not outline the potential nature and extent of the EOS ‘positive externalities’ or the non-financial opportunities and risks, that EOS objectives may bring about.
15. While being flexible enough to cover a wide range of potential EOS PRIIP applications, as well as future developments in this area, some limitation of this approach has to be accepted: in order to be able to judge on the basis of what is provided by the EOS PRIIP manufacturer, the client needs to understand the causal relation between the EOS objective as the starting point of the manufacturer’s investment strategy and its actual implementation as likewise set out in the IPS. The retail investor must be capable of assessing if the line of arguments used by the manufacturer to depict the investment strategy of the PRIIP is straightforward, self-contained and of sufficient impact in relation to the retail investor’s inherent EOS goals.

The assessment just outlined is inevitably left to the retail investor, as the real-world relations of EOS investments to their ultimate impact are far too complex and manifold to capture them in a rigid set of rules or even a template for eligible IPS.

16. In addition to being a “selling argument” towards the retail investor, the IPS helps the PRIIPs manufacturer to design and implement corresponding monitoring procedures and controls that foster the manufacturer’s own commitment to the objectives.

17. Clearly, the IPS must include principles on how the EOS objectives are put to work via the respective governance measures. Strict rules would lack the flexibility required to capture various EOS products and evolutions in the market.
18. The manufacturer shall express what way the social and/or environmental investment objectives are translated into specific products or specific asset classes. The design / selection criteria must contain and display a strong commitment of the PRIIP manufacturer to the stated objectives. By way of example, and in order to render a PRIIP 'green' or 'environmental', it may not be sufficient to avoid investment in fossil or nuclear energy (i.e. a pure *negative* or *exclusion strategy*, as mentioned in 3.3, would not suffice). Instead, straight links have to be given between a certain investment and EOS objectives<sup>24</sup>. These cause-and-effect relations must be depicted in a way that is accessible to the retail investor.
19. Moreover, investment in certain assets may rather have indirect, as opposed to direct EOS impact. Thus, the elaboration in the IPS on the link between the EOS objective(s) and the particular product, as well as the later monitoring, need to be more in-depth compared to a straightforward relation<sup>25</sup>.
20. An appropriate monitoring framework needs to be listed in the IPS and be part of manufacturers' investment strategy, to ensure a consistent ongoing implementation of the declared investment strategy. Granularity and sophistication of the necessary monitoring procedures, as well as the number of additional checks and controls (e.g. of the management of the chemical research company) for particular monitoring targets vary according to the 'need for explanation', i.e. the 'directness of impact', that a certain investment might have in respect of its qualification/eligibility as EOS.

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<sup>24</sup> E.g. pollution prevention, recovery of deteriorated natural resources, fostering (re-)integration of socially deprived citizens into labour force and similar straightforward intents.

<sup>25</sup> An investment e.g. in a wind farm could easily be regarded as 'directly environmental', whereas an investment in a company running chemical research only reveals 'environmental' elements, if the research output aims at e.g. improved energy storage of batteries for hybrid or electric automotive production or similar goals. In the latter case, adequate monitoring procedures have to be put in place in order to ensure that the company properly funds and manages its activities towards the goals that are referred to in the IPS of the PRIIP manufacturer.

### **Technical Advice 6: Monitoring Procedures and Controls**

*As part of the manufacturer's compliance with product governance measures the development and implementation of ongoing monitoring procedures and controls shall be sufficient to ensure investors can be confident that the investment strategy is properly implemented and adhered to over time. The IPS shall provide summary details on these measures, and where relevant, establish and explain links between the EOS PRIIP and its positive impact on publicly accepted and sustainable targets, also taking into account the more or less direct expected EOS impact.*

*These product governance principles should be applied in a proportionate manner: the more indirect the EOS impact of the PRIIP is, the more information must be provided and increased monitoring/control effort needs to be applied.*

21. The EOS PRIIP shall be reviewed by the manufacturer on an ongoing basis for its overall compliance with the investment strategy – and with EOS objectives in particular – as stated in the IPS.
22. In order to avoid the manufacturer becoming inure to potential shortcomings of this 'Best-effort approach' in day-to-day managing the EOS PRIIP, a regular review of the performance of the product and the processes put in place in view of the EOS objectives and the associated investment strategy in the IPS should be mandatory.
23. The frequency of the regular review shall be chosen according to features of the IPS, but shall be performed at least annually.
24. In order to be able to appropriately assess the impact of possible divergence from the IPS content, the retail investor shall be comprehensively informed about the outcome of the regular review without undue delay. In case of detected divergence, the manufacturer shall present to the retail investor a well-founded, effective and efficient schedule of steps for regaining full compliance with the EOS objectives of the PRIIP and the investment strategy, respectively.

### **Technical Advice 7: Review of EOS PRIIP**

*Manufacturers shall review the EOS PRIIP on an ongoing basis in order to ensure the product performs as intended, and assess compliance with the EOS objectives and the corresponding investment strategy as stated in the IPS. The review of the governance processes and performance of EOS PRIIPs shall be performed at least annually, with the actual frequency of reviews taking into account the complexity of the investment strategy and the IPS.*

*As part of the product governance rules, manufacturers shall establish and implement procedures and steps necessary and appropriate to restore compliance with the EOS objectives and investment strategy set out in the IPS.*

*Manufacturers shall inform retail investors in EOS PRIIPs about the outcome of their regular reviews and in particular about any significant deviations from the EOS objectives and investment strategy set out in the IPS and the procedures and steps to be implemented to restore compliance.*

## 5. Preliminary Impact Assessments

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### 5.1 Procedural issues and consultation of interested parties

According to the European Commission's mandate of 31<sup>st</sup> May 2016, the ESAs shall conduct analysis of costs and benefits when giving technical advice to the EC. The analysis of costs and benefits is undertaken according to an Impact Assessment methodology.

The draft Technical Advice and its impact assessment are subject to public consultation.

### 5.2 Problem definition

The Commission invites the Joint Committee to take account of the governance and supervisory requirements set out in sectoral legislation applicable to credit institutions, insurance undertakings, investment firms and alternative investment fund managers.

A natural starting point for rules directed at governance issues (and in following up to this on governance supervision) would be to define the scope of application. For the PRIIPs with environmental or social objectives, this scope would exactly be the corresponding class of PRIIPs which have underlying investments that dwell in a wider sense around areas of preventing pollution, fostering recovery of stressed natural resources ('environmental') or support activities that are generally regarded as socially desirable ('social').

The restrictions of the mandate ('no labelling') do not allow for any approach based on a legal definition of 'social' or 'environmental' investments. In addition, there is no such notion of 'environmental' or 'social' investments defined in EU law. Furthermore, it would most likely not be flexible enough to embrace all possible future innovations that could be regarded as effective EOS PRIIPs by retail investors. Thereby, such an approach could constrain the scope of EOS PRIIPs without immediate and good reason. Lastly, such a definition, if deemed to be necessary and justified at all cannot be established in a legally sound way in the Level 2 Regulations.

Rather the positive image of products with such welcome, non-financial objectives should be safeguarded against potential abusive marketing by PRIIPs manufacturers, that could 'greenwash' their products by brushing them 'environmental', 'social' or similarly designated.

The absence of a bespoke EOS regulatory framework or specific industry standards could promote innovation because of the freedom it offers, but it also factors in the proliferation of investment management and selection methods, as well as of "investible" asset classes, hindering clarity for the end investor.

Nevertheless, the described initiatives are not Union-wide accepted or even agreed and therefore have no impact outside their respective initiator's scope. PRIIP manufacturers can subject themselves to the transparency requirements of the industry standards mentioned under Section 3.2 on a voluntary basis. However, without prejudice to the liability resulting from the information

included in a prospectus (where available), the standards cannot be effectively supervised and retail investor rights may in many cases not be claimed in case of infringements.

The main problems to be addressed are therefore:

- Principles, criteria and processes, to be applied at manufacturer level (as no *brand* is created, that could be used when distributing to the retail investor), in order to narratively characterise certain PRIIPs as having (legitimate) environmental and/or social objectives.
- Enabling retail investors to find and invest in PRIIPs that might meet their requirement to invest responsibly.
- Ensuring that compliance with the stated environmental and/or social objectives is maintained over time via adhering to the manufacturer's IPS, which translates the abstract objectives into an operational framework of boundaries to the investment activity of the manufacturer on behalf of the retail investor.

### Baseline scenario

When analysing the impact from proposed policies, the impact assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention.

The baseline scenario is the situation where the PRIIPs Regulation applies, but where there is no Delegated Act by the EC to further specify the prerequisites and obligations that Article 8, para 3 (ii) imposes on the PRIIPs manufacturer (which states that 'The key information document shall contain [...] under a section titled 'What is this product?', the nature and main features of the PRIIP, [...] including, where applicable, specific EOS objectives targeted by the product [...]'). This provision only relates to necessary entries in the KID.

No further requirements are given in the PRIIPs Regulation regarding the statement of the manufacturer on an investment strategy that is consistent with the EOS objectives, nor the necessary commitment of the manufacturer to such strategy and its proper implementation in a legally binding way.

## 5.3 Objectives

The overall objective of a Delegated Act would be to ensure that sufficient and reliable information on EOS objectives of a PRIIP and the ways and means of how to achieve them is given to the retail investor. Thereby, the retail investor should be enabled to take into account or even put considerable weight on EOS objectives when making an investment decision. Thus, financial markets clients could in the future effectively add an 'EOS dimension' to their investments. By ensuring a well-functioning framework for 'EOS governance', they could rely on the products they choose in the sense that they actually pursue the goals stated in a monitored fashion. This helps

to increase credibility of such products and thus gauge investment in assets with ethically responsible ‘side effects’.

The policy issues to address are as follows:

- Approaches for identification of EOS objectives of a PRIIP;
- Defining substance of information to client on EOS objectives;
- Processes for manufacturer’s compliance with EOS objectives.

## 5.4 Policy options

This section explains the rationale behind the most relevant alternative solutions that the Joint Committee has examined when designing the Technical Advice. This means, that the following policy options have been regarded ex ante to the choices, that led to the draft Technical Advice under section 4.

### **Policy issue 1: Approaches for identification of EOS objectives of a PRIIP**

**Option 1.1:** No information in addition to notification in ‘What is this product’ section

**Option 1.2:** Common principles (minimum standards)

In order to achieve the policy objective under 5.3, it is necessary, but not sufficient, to state to the retail investor what EOS objectives a particular PRIIP pursues. It is immediately clear that not every goal that can be established for a PRIIP investment to aim for, can serve as an EOS objective. Thus, there must be some approach to delineate sensible EOS objectives from those that are obviously misleading or false.

A first attachment point for the retail investor in search of EOS PRIIP investments is – for future reference – surely the KID itself. As already mentioned, Art. 8 (3) (ii) of the PRIIPs regulation requires the manufacturer to reveal the EOS objectives of his/her PRIIP in the ‘What is this product’ section.

If there was no further requirement on the statement of EOS objectives, it would be left to the manufacturer to state for an arbitrary, loose objective for his/her PRIIP, making it looking environmental and/or social and presenting it in a manner that is appropriately concise for the named KID section.

### Policy Option 1.1: No information in addition to notification in ‘What is this product’ section

No.	Pros	Cons
1	Effortless, low cost way of stating EOS objectives	High risk of mis-sellings of non-eligible products to investor base that seeks responsible investments.
2	-	Degree of achievement of stated objectives cannot be assessed à posteriori.

### Policy Option 1.2: Common principles (minimum standards)

No.	Pros	Cons
1	Nature of EOS objectives requires elaboration on the relation between investment and desired impact, which can be covered by common principles.	Minimal standards may still leave room for divergence in approaches; therefore potential remains for some retail investors to misunderstand or be misled by objectives <sup>26</sup> .
2	Degree of achievement of stated objectives can better be assessed than with option 1.1.	Minimal standards may still leave room for some legal uncertainty/legal risk for manufacturers in assessing compliance.
3	Better awareness of manufacturer about what to be compliant with and how to achieve compliance.	More costly than option 1.1, as implementation of principles triggers intellectual and practical efforts.
4	More information enables retail investor to better assess if the given objective meets his preferences.	

The impact assessment for Policy Issue 1 leads the ESAs to choose Policy Option 1.2, due to the superior balance of arguments in favour, over those against compared to the alternative.

### Policy issue 2: Defining substance of information to client on EOS objectives

**Option 2.1:** Flexibility in providing information

**Option 2.2:** IPS as the basis for overall EOS product governance on PRIIPs

**Option 2.3:** Additional disclosure on EOS objectives

<sup>26</sup> Knowing, that the European Commission explicitly excluded any approach that might – directly or indirectly – result in any kind of labelling of products as ‘E’environmental or social’E’, the ESAs refrained from entering into exploration of more elevated standard type of approaches, as such would inevitably lead to de-facto ‘labelling’.

After having determined the particular EOS objectives towards the retail investor, the manufacturer must demonstrate to the retail investor (and indirectly also to the supervisor) what processes are envisaged for the implementation of the product's investment strategy in the day-to-day investment process in order to achieve the objectives.

Alternatives range from giving the manufacturer discretion about how to provide the information to the retail investor (Option 2.1) to presenting it within the IPS (option 2.2) or to more far-reaching, detailed elaboration in a dedicated document for this purpose (Option 2.3).

### **Policy Option 2.1: Responsibility of the manufacturer**

<b>No.</b>	<b>Pros</b>	<b>Cons</b>
1	Low cost and liability for manufacturers.	May lead to 'do nothing' solution by manufacturers, thus increasing the risk of wrong decisions by retail investor and depreciation of market of EOS PRIIPs.
2		Divergence in approach with varying quality of information.
3		Could lead to render virtually any PRIIP to have EOS objectives.

### **Policy Option 2.2: IPS as the basis for overall EOS product governance on PRIIPs**

<b>No.</b>	<b>Pros</b>	<b>Cons</b>
1	Product information needs to be provided in some instances by existing requirements on Level 1 (e.g. by prospectus, where available).	Still divergence in approaches possible with the risk of ill-perception or mis-interpretation by the retail investor, though to a lower degree than under option 2.1
2	Flexibility and proportionality automatically addressed by way of existing IPS requirements.	No formal requirements for IPS information at level one.
3	Increased comparability across different EOS PRIIPs.	

### Policy Option 2.3: Additional disclosure on EOS objectives

No.	Pros	Cons
1	Sufficient space for elaborating on EOS objectives and their implementation	Additional amount of time for retail investor to read and digest information.
2		More costly to implement.

The impact assessment of Policy Issue 2 results in the ESAs choosing Policy Option 2.2, due to the superior balance of arguments in favour, over those against compared to Options 2.1 and 2.3.

### Policy issue 3: Safeguards for manufacturer's compliance with EOS objectives

**Option 3.1:** Relying on existing product governance and oversight measures in existing Level 1 legislation

**Option 3.2:** Create principles for monitoring obligations in order to reflect the specific nature of EOS objectives

**Option 3.3:** Create specific monitoring requirements for all EOS PRIIPs and objectives

The transposition of EOS objectives into operable investment criteria needs to be followed by appropriate monitoring and control measures at the side of the manufacturer in order to ensure ongoing compliance with the IPS. The reference point for what shall be achieved by investing the retail investor's funds must be at all times the IPS.

Possible solutions comprise of the following:

- Follow the range of monitoring processes, system and controls that need to be established according to existing Level 1 legislation for different types of (EOS) PRIIPs,
- A principle-based approach that leads to clear conclusions what checks and balances are necessary (or not) against the background of a given set of EOS objectives, and
- Particular monitoring and controls that are mandatory for any EOS PRIIP.

**Policy Option 3.1: Relying on existing product governance and oversight measures in existing Level 1 legislation**

No.	Pros	Cons
1	Simplicity, low costs of implementation.	Diverging requirements in Level 1 EU legislation (e.g. MiFID II, AIFMD, UCITS or IDD).
2	Legal clarity.	

**Policy Option 3.2: Create principles for monitoring obligations in order to reflect diverging nature of EOS objectives**

No.	Pros	Cons
1	Adaptability for specific EOS objectives.	Legal uncertainty, with some additional costs.
2	Proportionality can be easily achieved.	
3	Can be enhanced by manufacturer for additional product safety.	

### Policy Option 3.3: Create strict monitoring rules for all EOS PRIIPs and objectives

No.	Pros	Cons
1	Legal clarity.	Inflexible approach.
2	Can be checked easily by supervisors.	Not proportional, as all EOS PRIIPs need to comply with the same POG obligations (also: costly).
3		Specific compliance risks (in terms of EOS objectives) might not be appropriately targeted.

The outcome of the impact assessment for Policy Issue 3 involves the ESAs choosing upon a combination of Policy Options 3.1 and 3.2, whereby existing POG rules were found to generally cover necessary governance requirements, given that they are interpreted according to the specific nature of EOS objectives. Thus, the additional burden, particularly with respect to disclosure, but also for other governance areas, is limited, while the proportionality, flexibility and – most important – product safety aspects can be maintained.

## 5.5 Analysis of impacts

Regardless of the qualification of EOS objectives as ‘hard’ / ‘first order’ or ‘soft’ / ‘second order’ parameters for an investment decision, these type of rather ‘desired’ goals of retail investors have played an increasing role in retail financial markets for approximately a decade.

The nature of investment objectives, that may qualify as EOS objectives require an approach that reflects the vast range of EOS objectives and they might be connected to a PRIIP. A high degree of flexibility must be inherent to the legislative solution to the regulatory problem of EOS PRIIPs in order to achieve a sufficient level of retail investor protection along with growing investment opportunities for retail investors. Such flexibility seems to be best achieved by principle-based options for the policy issues listed above.

While the particular application of such principles nevertheless requires some additional Level 2 work, it is already covered by Level 1 legislation, which thus does not need to be amended. Nevertheless, the application of the proposed principles needs to be properly framed to result in:

- Informative, non-misleading IPSs in respect of the specific EOS objectives, to be provided by the EOS PRIIP manufacturer,
- Proportional implementation effort during the manufacturing process for EOS PRIIPs, and
- Sufficient and appropriate governance measures on the manufacturing side in order to ensure a high degree of achievement for EOS objectives.

## Benefits

Positive credibility for PRIIPs with EOS objectives, as well as for retail financial markets as a whole, could arise from an appropriate regulatory approach to framing eligible and sensible retail investor information on such objectives.

Therefore, it must be ensured that the requirements are not too burdensome for manufacturers in order to foster the innovative power of financial markets towards EOS targets. On the other hand, information given to the retail investor must be accurate in that nothing is promised for the specific PRIIP that cannot be provided by the manufacturer to the retail investor with a sufficiently high degree of security. Otherwise, retail investors may lose the desirable objectives of such PRIIPs in the medium term.

Market growth, investor responsibility and yield can be achieved at once by suitable principle-based regulation that results in a high commitment to EOS objectives both on the manufacturer and retail investor sides.