# Investment Association Supplementary Comment on the EU Renewed Sustainable Finance Strategy

### *About the Investment Association*

The Investment Association (IA) represents over 250 UK-based investment management firms who collectively manage assets totalling EUR 8.7 trillion, of which EUR 2 trillion is on behalf of continental European clients. The UK investment management industry is a key part of both the UK and EU's financial ecosystems, helping millions of individuals save for the long-term and enabling them to enjoy a more prosperous retirement. The UK investment management industry is the largest in Europe and the second-largest globally.

## Overarching Comment

The IA is supportive of the European Commission committing to a comprehensive and ambitious strategy to channel private capital towards sustainable investments (Strategy Consultation 2020, p.4).

Since the start of this year, we have witnessed a global pandemic bring devastation to communities across the globe, disrupt economies and businesses and the nature of social interaction on an unprecedented scale. The importance of building a more resilient, sustainable financial system is now even more timely than ever.

As investment managers, we seek to deliver on our clients' investment goals, including the generation of long-term sustainable returns and, where appropriate to the investor, allocation of capital to investment strategies with environmental or social characteristics or in the pursuit of specific sustainability objectives.

As you may know, the industry is taking forward a number of proactive initiatives to further develop and embed sustainable finance across investment management. We hope this work will complement and reinforce the Commission's efforts, as we work together towards a more sustainable future for financial services and society.

**First-ever industry-agreed Responsible Investment Framework**

At the end of last year, the IA published its Responsible Investment Framework to help articulate clearly and consistently the different ways in which investment managers contribute to sustainability through responsible investment practices. This is being increasingly used as a reference point across different jurisdictions as well as helping to bring clarity to investors.

This year, building on the Framework, the IA is developing guidance on the communication of responsible investment characteristics of funds. This builds on the regulatory requirements set out under the Sustainable Finance Disclosure Regulation (SFDR) and seeks to assist investment advisers to understand and ascertain the sustainability preferences of their clients pursuant to the amended MiFID Suitability Assessment.

As we explore in our responses to the specific survey questions in more detail, the industry is also developing detailed recommendations for a UK retail product label. This is intended to help bring clarity to investors and to help channel capital to responsible and sustainable investment.

**Other notable initiatives**

The industry is also undertaking work on the relationship between asset owner and investment manager, as this relationship sets the tone for responsible allocation of capital and reinforces expectations on companies to act in the long-term interests of their shareholders. It therefore acts as a critical lever for ensuring a long-term approach to investment. Specifically, The IA is undertaking work in this area with a focus on ESG integration, effective stewardship and the treatment of long-term systemic risks such as climate change. This extends to the selection and appointment of managers, their contractual relationship and ongoing performance and oversight. We very much welcome the Commission's recent efforts to ensure financial markets are set up to deliver long-term value, including the Shareholder Rights Directive II (SRD II), and are confident our own proactive work helps to drive forward this agenda alongside the Commission's initiatives.

**Our high-level view on key issues raised by the consultation**

***Investment Managers' Duties to Act in the Best Interests of Clients***

As the Commission has demonstrated through the breadth of its European Green Deal, facilitating the transition to a sustainable financial system and society is not a task for financial services alone. Instead, it is a collaborative effort including government policy and action, financial services identifying and responding to sustainability-related risks and opportunities, and changes to corporate behaviours.

It is therefore crucial that each actor contributes in a way that is suitable to their role and responsibilities in society. For this reason, we would caution against adjustments to investment managers' duties that are proposed in this consultation. Part of investment managers carrying out their duties to act in the best interests of clients is to consider and integrate material environmental, social and governance risks for the generation of long-term sustainable returns. There may be some instances where value to society or the economy conflicts with value to beneficiaries. In such instances, it must be recognised that the client/beneficiaries should take priority.

Should a client wish to indicate a preference for their manager to prioritise the mitigation of adverse impacts over returns for a specific time horizon, mechanisms exist to provide this clarity. Investment managers should make use of communication through fund literature or mandates to ensure they are clear about whether they will act to prioritise mitigating adverse impacts or seek return regardless of the impact. This way, the mandate or fund objective, takes priority and the question of duties becomes less important, as the contractual obligation to fulfil the mandate takes precedence.

As outlined above, the IA is carrying out work helping to articulate choices to investors through enhancing disclosure through fund documentation and investment mandates to improve clarity and communication between investment managers and their investor. We would be very happy to share our findings with you.

***Clear Policy Signals and the Role of Governments***

Alongside investment managers' consideration and integration of material ESG risks, governments can play a key role in bringing negative externalities onto businesses' balance sheets, for example, through effective carbon pricing and fiscal measures.

We welcome the Commission's focus on measures to encourage more sustainable behaviours in the real economy. These, in turn, help financial services price externalities into their valuations effectively. This way, we are better able to identify which businesses are likely to provide a long term sustainable return to savers and which are less likely to.

It is important for market participants to receive clear and advance notice of policy decisions to allow them to process and adapt to policy changes. In-scope entities will need to consider the extent to which policy changes impact their asset pricing, business models and strategic approach, including existing regulatory and reporting obligations. Additionally, any such policy decisions should be made in consultation with corporates and financial institutions.

***Regulatory Intervention and Bolstering Sustainable Finance***

**Transparency.** The industry is supportive of efforts to bring about greater transparency and comparability to sustainability-related disclosures. At every step of the investment chain, it is important that we receive meaningful and robust sustainability-related information, upon which to make investment decisions. This applies for investment managers receiving decision-useful information from corporates but also for investors and savers receiving decision-useful information from investment managers. Effective regulation can help equip organisations and individuals to make informed decisions along the investment chain. For investment managers, this may refer to the identification of material ESG risks and opportunities. For a retail investor, this may refer to the identification of products or services that meet their sustainability preferences. We need to help retail investors understand the choices they are making by providing them with the necessary tools to do so. It is most important that regulatory intervention is used to inform decision-making and choice as opposed to prescribing investment approaches or restricting choice.

**Link to Real Economy.** More broadly there should be alignment between regulatory mandates placed on the financial sector with that of the real economy. The financial sector is a supporting or facilitating sector. The current workplan seems to assume the transition will occur more through indirect regulation of finance rather than direct regulation of primary sectors. For example, the removal of fossil fuel subsidies and the incentives they create is not dependent on the financial sector or a Brown Taxonomy.

**International Cooperation.** The industry is committed to supporting the EU in being a global leader in sustainable finance. Nevertheless, we know that climate change is not something that one jurisdiction can solve alone. For this reason, we would ask that the EU also consider lending its voice and pioneering methods in support of global initiatives. Fragmentation of financial markets due to different regulatory requirements stands at odds with the need to work collaboratively to address what are global issues (e.g. climate change). The EU should also work to support international standard setting with the standard setting bodies (IOSCO, BCBS, IAIS) as well as an overall coordinated agenda via the G20 / FSB.

**Regulatory alignment.** It is important that different regulatory requirements are aligned across the investment chain and sequenced appropriately. For example, the Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy disclosure requirements need high-quality data from corporates. Thus, we consider that Non-financial Reporting Directive (NFRD) requirements should be designed to ensure this data need is met, particularly if a detailed and granular approach is taken with respect to adverse impacts and other required disclosures by financial firms. Similarly, changes to organisational requirements through amendments to MiFID, UCITS and AIFMD delegated acts link to reporting requirements under SFDR; and the regulatory technical standards providing requisite detail to the disclosures under SFDR are not expected to be ready until after the 10 March 2021 implementation date. These timeline challenges and interconnections mean that only once all regulatory changes are in place will financial services firms be able to implement them fully and only at that point will it be possible to judge their effectiveness in a truly meaningful way.

**Time to bed in.** Similarly, the last two years of debate in sustainable finance have started a sea-change in awareness, attitudes and behavioural changes in relation to sustainability and sustainable finance. This is no small part thanks to the discussions driven by the first Action Plan in 2018. We are confident that the full impact of that Action Plan has not yet been felt and would recommend we take a moment to allow the various different pieces of regulation to bed in (particularly given their varying timelines) to be assessed as a whole in order to understand their effectiveness, before looking to further regulatory change.

## Rationale to Specific Survey Responses

**There are a number of survey questions where we have been unable to submit a rationale to accompany our “Yes/No” response. Please find this rationale directly below:**

**Question 16:**

Do you see any further areas in existing financial accounting rules (based on the IFRS framework) which may hamper the adequate and timely recognition and consistent measurement of climate and environmental risks?

**IA Response:** No

**Rationale:** There is already sufficient flexibility within the existing accounting rules to allow for the consistent measurement of climate and environmental risks. While the IFRS requirements do not explicitly mention climate-change, the IASB has made it clear that the standards address issues relating to these risks. The key question is how to ensure that auditors and directors consider these risks.

**Question 28:**

In its final report, the High-Level Expert Group on Sustainable Finance recommended to establish a minimum standard for sustainably denominated investment funds (commonly referred to as ESG or SRI funds, despite having diverse methodologies), aimed at retail investors. What actions would you consider necessary to standardise investment funds that have broader sustainability denominations?

**IA Response:** No regulatory intervention is needed

**Rationale:** We agree that it can be confusing for investors to understand the diverse range of sustainable and responsible approaches that exist in the market today, but we would not advocate for standardisation of those approaches. Different investors will have different preferences and strategies, and we would not support action that sought to narrow this universe of funds. Instead, it is bringing improved transparency and greater consistency to how funds disclose their responsible investment characteristics that will help investors identify products to suit their sustainability preferences.

There are a number of initiatives already underway to help investors identify suitable sustainable products for them, and we would ask that these initiatives are given time to bed in before considering further change.

1/ Amendments to the MiFID Suitability Assessment

We are supportive of new rules for advisers to proactively ascertain the sustainability preferences of their clients. This is a monumental step which needs time to develop for us to assess its impacts.

2/ SFDR and the EU Taxonomy

SFDR and the Taxonomy will have a significant impact on the information that is disclosed to investors at fund level. We need time to assess how this will impact investor choice.

3/ Proactive industry work

In November 2019, the IA published its Responsible Investment Framework to explain how investment managers carry out responsible investment. It shows that firms carry out ESG integration, corporate engagement activities and even exclusions at a firm-level, whilst applying different approaches on a product-by-product level, including, for example, the application of sustainability themes or best in class approaches. It also captures products that pursue certain sustainability objectives through impact investments. The Framework was a significant first step in establishing a common language through which to communicate the broad range of ways in which investment managers contribute to sustainability through responsible investment.

Building on this Framework, the industry is carrying out proactive work on the communication of responsible and sustainable investment characteristics at the product level. This work takes a holistic view along the length of the distribution chain and is intended to help investment managers communicate the responsible characteristics of their funds clearly. This is to ensure distributors receive the necessary information to allow them to assess the sustainability preferences of their clients to offer suitable responsible investment products, and is intended to complement the incoming regulatory changes.

**Q. 35. Do you think the existing capital market infrastructure sufficiently supports the issuance and liquidity of sustainable securities?**

**IA Response:** 4 - Agree

**Rationale:** The IA does not consider that the existing capital market infrastructure presents significant barriers to the issuance and liquidity of sustainable securities.

The primary issues facing the sustainable securities market at present are:

- A lack of liquidity resulting from the relatively small size of the market at present; and
- A lack of a standardised approach as to how sustainable instruments are labelled, defined and reported on.

The IA does not consider that these issues are best tackled through changes to the capital markets infrastructure itself. Instead, we welcome the development of European and ultimately global standards to communicate the responsible and sustainable characteristics of investments to bring greater clarity and comparability to sustainable securities.

**Question 40:**

In your view, should there be a mandatory share of variable remuneration linked to non-financial performance for corporates and financial institutions?

**IA Response:** No

**Rationale:** Executive remuneration can be used as a mechanism to ensure that the incentives of executives are aligned with the time horizons of investment beneficiaries. Poorly designed incentive schemes can act as a disincentive to invest in capital expenditure and research and development and can incentivise short-term outcomes over longer term value creation and can therefore be symptomatic of wider governance issues at a company. Effective Director remuneration structures support performance, encourage the sustainable financial health of the business and promote sound risk management for the success of the company and to the benefit of all its stakeholders.

Companies and their remuneration committees should select remuneration structures that are appropriate to their specific business needs and long-term strategy, this includes the selection of the appropriate performance conditions under these remuneration structures. Alignment between executive pay and strategy is key to providing the correct incentives for the executives to deliver on the implementation of the strategy and for producing long-term value for the company and shareholders alike. It is important for Boards to target the key areas which they wish their executives to be focused on in implementing the strategy. This will differ between companies and sectors.

Boards are increasingly introducing non-financial performance metrics where they are material to the implementation of the company's strategy and delivery of long-term value for shareholders. This is a welcome development and we would expect it to evolve as the importance and materiality of those non-financial metrics continues to become more apparent. The Shareholder Rights

Directive II already encourages companies to indicate their non-financial performance in their remuneration committee and calls for remuneration policies to contribute to the sustainability of the company. In our Long-Term reporting Guidance, the IA has also asked companies to disclose "whether the remuneration committee is able to consider corporate performance on ESG issues when setting remuneration of executive directors. If the report states that the committee has no such discretion, then a reason should be provided for its absence and whether the remuneration committee has ensured that the incentive structure for senior management does not raise ESG risks by inadvertently motivating irresponsible behaviour."

Ensuring that the adopted metrics are material to the needs of the company can only be achieved through bespoke remuneration structures that take account of the unique circumstances of each company. We would therefore oppose mandatory measures as proposed by the consultation.

Mandating a share of executive pay be linked to non-financial performance would reduce the flexibility for boards to choose the most appropriate performance measures for their company.

**Question 41:**

Do you think that a defined set of EU companies should be required to include carbon emission reductions, where applicable, in their lists of ESG factors affecting directors' variable remuneration?

**IA Response: No**

**Rationale:** Companies should focus on remuneration metrics which are material to the implementation of the company's long-term strategy. The increased adoption of carbon emission targets in remuneration structures reflects an increased understanding of their importance. However, these targets will not be appropriate for all companies and may not be a material metric to the implementation of the company's strategy.

This will differ according to the sector: carbon emissions is likely to be a more appropriate target for Oil & Gas companies than for companies in other sectors. The Company should have the flexibility to choose the most material metric based on the individual circumstances of the company and their strategy.

**Question 42:**

Beyond the Shareholder Rights Directive II, do you think that EU action would be necessary to further enhance long-term engagement between investors and their investee companies?

**IA Response:** No

**Rationale:** The Shareholder Rights Directive II puts a renewed focus on how asset owners ensure their investment strategy is aligned with the profile and duration of their liabilities. We would suggest giving the revised Directive time to bed in before focusing on additional interventions.

**Question 44:**

Do you think that EU action is necessary to allow investors to vote on a company's environmental and social strategies or performance?

**IA Response:** No

**Rationale:**

- We would not suggest action at this stage but improvements to companies' disclosures on their environmental and social strategies should be closely monitored to allow us to take stock of whether further action may be needed at a later stage.
- Focus should be placed on setting standards for corporate reporting on environmental and social matters so that performance on these matters can be assessed. This provides opportunities for investors to engage with companies on the quality of their reporting and on the level of their performance. If these financially material disclosures are properly reflected in company reports and accounts then investors can choose to vote against the reports and accounts if they do not feel that companies have appropriately reflected the impact of environmental and social issues on their long-term performance. Shareholders do also have the ability to requisition resolutions on specific matters, where they do not believe they are being addressed through standard resolutions. Increasingly investors are collaborating to hold companies to account on managing their response to climate change.
- It is not clear how impactful a vote on social and environmental strategies could be where this could relate to a very wide range of issues.
- Reforms to director duties and encouraging companies to be more explicit about how they have given regard to key stakeholders, including the environmental and society would better enable investors to hold individual directors to account for how they are managing these issues.

**Question 46:**

Due regard for a range of' stakeholder interests', such as the interests of employees, customers, etc., has long been a social expectation vis-a-vis companies. In recent years, the number of such interests have expanded to include issues such as human rights violations, environmental pollution and climate change. Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?

**IA Response:** Yes, as these issues are relevant to the financial performance of the company in the long term.

**Rationale:** Our answer is informed by the UK experience, where company Directors' primary duty is to the shareholders, but where they also have an explicit duty 'to have regard to' the consequence of any decisions the company's employees, and the impact of operations on the community and environment amongst other things (as is set out in Section 172 of the UK Companies Act).

As custodians of long-term capital, we favour companies that can demonstrate they are well run and take a long-term view of how they treat their employees, communities, suppliers, pension savers and customers. Our industry's role is to cut through economic uncertainty and market volatility, to work with and support good businesses that produce sustainable long-term value for savers and investors

Our members have long held the belief that the prosperity of companies is built by the people who work in them, the communities they operate in, and the customers they serve. Directors have a duty to promote the success of the company for its owners – the shareholders – and are required by law to have regard for the likely long-term consequences of decisions, and the interests of employees, suppliers, customers and the community. Companies that are good at managing relationships with these stakeholders and think of the long-term will build a stronger strategy and make better business decisions which will deliver long-term returns for the company and shareholders. In 2018 new reporting requirements were enacted for companies to report on how they are fulfilling their Directors duties.  Companies are required to provide disclosures in their latest Annual Report.

These core components of a well-run company have been thrown into sharp relief by the coronavirus pandemic. Our members continue to engage with investee companies on how they are treating their employees, from promoting the physical and mental health of their workforce to how they are investing in training and support for them. They are also looking closely at how companies are engaging with other key stakeholders, including communities, suppliers and customers to inform their business decision making.

There will be a real opportunity to identify best practice in terms of those companies that have excelled in these areas. In the UK, the new reporting requirements will help shareholders to identify how companies have fulfilled their Directors Duties through this crisis and hold laggards to account.

**Question 47:**

Do you think that an EU framework for supply chain due diligence related to human rights and environmental issues should be developed to ensure a harmonized level-playing field, given the uneven development of national due diligence initiatives?

**IA Response:** No

**Rationale:** Supply chain risk is a key area that needs further scrutiny from companies, with respect to environmental and social issues, such as climate change and modern slavery, but also in relation to wider financial and strategic issues such as cash flow management and systemic risks. The recent pandemic has clearly illustrated the essential role that company supply chains play in determining their long-term sustainability. The consultation is right to point out that there have been varying oversight requirements by different EU Member States and a more consistent approach would help to drive up standards. However, it is not clear that the development of an EU framework would be the most efficient way of achieving this. Instead, the EU could look to ensure that management of supply chain risk is properly reflected in Directors' Duties.

In addition, in its review of NFRD the Commission should ensure that more emphasis is put on companies disclosing their approach to managing supply chain risks. As we set out in our consultation response, SASB and TCFD should be starting points for evolving non-financial disclosure standards and the Commission should work with the secretariats of these standards and frameworks to ensure that their approach to supply chain risks is fully developed and that there are clear, industry-specific guidelines on which supply chain risks are most likely to occur in different sectors. The United Nations Global Compact (UNGC) principles and the Organization for Economic Co-operation and Development (OECD) guidelines for multinational enterprises to assess companies' norms, including human rights abuses, labour laws and standard climate related practices and ILO standards are also relevant for this particular topic.

As is clear from learnings from the introduction of the Modern Slavery Act, this work stream needs to focus on how companies are engaging with their supply chains to minimise risks, in recognition that behavioral changes in smaller entities, particularly in emerging markets require sustained attention.

**Question 50:**

Do you think that retail investors should be systematically offered sustainable investment products as one of the default options, when the provider has them available, at a comparable cost and if those products meet the suitability test?

**IA Response:** No

**Rationale:** If we have understood correctly that "default" refers to one of a number of options, from which an investor makes a *choice*, we do not support this proposal.

Advisers should assess and seek to meet the needs of retail investors based on each retail investor's particular needs and goals.

Certainly, this should not preclude offering sustainable investment products, should such products meet the needs and goals of that particular retail investor. However, introducing a *requirement* to *systematically* offer sustainable investment products could lead to a conflict of interests for the adviser seeking to comply with the requirement to offer sustainable investment products and at the same time seeking to assess what is best for the investor. This in turn runs the risk of increasing mis-selling.

Should a sustainable investment product genuinely suit the needs of a retail investor based on the assessment made by an adviser, an additional requirement to include the product in the list of options put to the retail investor should not be necessary.

In place of requiring the provision of such products, we continue to support and take forward work to improve the clarity of fund-level communication to empower retail investors to make informed choices.

**Question 91:**

Do you see merits in adapting rules on fiduciary duties, best interests of investors/the prudent person rule, risk management and internal structures and processes in sectorial rules to directly require them to consider and integrate adverse impacts of investment decisions on sustainability (negative externalities)?

IA Supplementary Comment (15.07.20)

**IA Response:** No

**Rationale:** We would caution against adapting rules on fiduciary duties for two main reasons:

1/ Protecting, and respecting the choices of, investors and savers; and

2/Allowing time to assess the impact that existing regulatory change will have on the market before making further changes.

Both national governments and the private sector have a role to play in meeting our sustainability commitments and ambitions. Governments can play their role in bringing externalities onto balance sheets, for example, through effective carbon pricing and fiscal measures. Transparency by investment managers, too, plays a role in showing how these externalities are considered, including demonstrating the impact of investments on people and planet. We are therefore supportive of efforts to help market participants price in negative externalities, alongside appropriate policy signals and action from governments, but would caution against adapting fiduciary duties for the reasons below.

<u>1/ Protecting, and respecting the choices of, investors and savers</u>

Part of investment managers carrying out their duties to act in the best interests of clients is to consider and integrate material environmental, social and governance risks for the generation of long-term sustainable returns. There may be some instances where value to society or the economy conflicts with value to beneficiaries. In such instances, it must be recognised that the client/beneficiaries should take priority.

Should a client wish to indicate a preference for their manager to prioritise the mitigation of adverse impacts over returns over a specific time horizon, mechanisms already exist to provide this clarity. Investment managers should make use of communication through funds or mandates to ensure they are clear about whether they will act to prioritise mitigating adverse impacts or seek return regardless of the impact. This way, the mandate or fund objective, takes priority and the question of duty becomes less important, as the contractual obligation to fulfil the mandate takes precedence.

The IA is carrying out work both on fund documentation and investment mandates to improve clarity and communication between investment managers and their investor. We would be very happy to share our findings with you.

<u>2/Allowing time to assess the impact that existing regulatory change will have on the market before making further changes</u>

Investment managers are preparing to make new disclosures under the Sustainable Finance Disclosure Regulation (SFDR) from next year. The industry has been intensely engaged on the development of SFDR and recognises the sea-change this piece of regulation could bring. The mandatory disclosure of adverse impacts from June next year will be a significant step in bringing clarity to the identification and management of negative externalities and we are working hard to ensure these new measures are meaningful and decision-useful in practice. We would ask that you allow time for SFDR to be implemented and to see its impact on behaviours, before further changes are made.

Finally, the industry is keen to ensure it has understood the spirit of each new piece of regulation from the Commission. We would therefore welcome additional clarity on precisely how this part of the renewed strategy is intended to interact with the proposed changes to the UCITS/AIFMD delegated acts to integrate sustainability risks and adverse impacts

**Question 94:**

In view of the planned review of the IORP II Directive in 2023, should the EU further improve the integration of members' and beneficiaries' ESG preferences in the investment strategies and the management and governance of IORPS?

**IA Response:** No

**Rationale:** A useful distinction here is between financial and non-financial matters. IORPs should always take into account financially material ESG risks (ESG integration). They *may* take into account the non-financial concerns of beneficiaries (ESG preferences), provided that the concern is generally shared and where there is no significant risk to beneficiaries' outcomes.

Through the investment of their money, beneficiaries have a stake in the way that an IORP conducts investment activity. Formulating investment policies having at least attempted to understand beneficiaries' ESG preferences may help increase member engagement, which is positive.

However, we do not advocate a requirement to *incorporate* beneficiaries' ESG preferences into the investment strategy. The challenge is both theoretical and practical. At the theoretical level, we do not see how the fiduciary duty that IORPs owe to their beneficiaries is compatible with the possibility that an investment strategy that incorporates beneficiaries' ESG preferences may result in a worse financial outcome than an alternative strategy in which financially material ESG risks are fully integrated, but which does not reflect beneficiaries' ESG preferences. 'At a practical level, an IORP is a collective scheme, and unless all beneficiaries share the same broad ESG preferences, it will be impossible to reconcile views.

Thus, while IORPs should seek to understand beneficiaries' ESG preferences, they should not have to definitively implement them as part of the IORP's investment strategy, doing so only where the preferences are widely held across the beneficiaries and where there is no significant risk to their outcomes.