THE
INVESTMENT
ASSOCIATION

Response to consultation

Consultation on the amendments to the Delegated Regulation (EU) No 231/2013 as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage € 8.5trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Overarching Comment

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 certain sustainability objectives. We are committed to the growth and development of sustainable finance and support European policymakers' demonstration of global leadership. Specifically, we welcome the Sustainable Finance Package with its broad objectives to 1) reorient capital flows towards sustainable investments, 2) manage financial risks stemming from ESG issues; and 3) foster transparency and long-termism in financial and economic activity.

We thank the Commission for this opportunity to provide feedback on the Draft amendments to the Delegated Regulation (EU) No 231/2013 as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers

We welcome these efforts to ensure that firms take account of material sustainability risks in their processes and organisational requirements. We are particularly supportive of these measures being reflective of a principles-based approach when it comes to the incorporation of sustainability considerations within a firm's processes, systems and controls. We support this approach as it ensures flexibility and therefore, more efficient applicability for firms as these differ in size, internal organisation and the nature, scope and complexity of the business conducted.

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We also welcome the clarity that has been brought to the definitions of "sustainability factors" and "sustainability risks" and the alignment of these with the definitions set out in Article 2 point (22) of Regulation (EU) 2019/2088. We note that the overall proposals help to clarify where sustainability factors should be taken into account by Alternative Investment Fund Managers ('AIFMs') as part of their duties towards investors across the entity processes, systems and internal controls as well as within risk management process and adequate resources and expertise for the effective integration of sustainability risks.

However, despite this broad support, we have some outstanding concerns around the drafting which we seek to resolve below, including specific drafting suggestions.

Summary of Key Issues

1. Interconnectedness of the sustainable finance regulations
    - It is important to take a holistic view of the different component parts of the Sustainability Finance Action Plan and how they interact. We will only be able to assess the effectiveness of the changes across the piece once all new aspects have had time to bed in, given that there are issues with sequencing as it currently stands.
2. Sustainability risk assessment
    - Concerns around data availability and the need to recognise the importance of qualitative assessment
    - Need to ensure proportionality of sustainability risks alongside other risks
3. Proposal to include principal adverse impacts in due diligence process
    - Concerns around misalignment with other parts of the package, which take a less prescriptive approach and instead are predicated on the importance of transparency and investor choices (Regulation (EU) 2019/2088)
    - Possible conflicts with investment managers' duties to act in the best interested of investors

Detailed comments and drafting suggestions

1. Interconnectedness of the sustainable finance regulations

Timing and harmonisation

We welcome the addition of proposals to strengthen the alignment with existing regulations, in particular, the Regulation (EU) 2019/2088. However, we note that the organisational requirements on sustainability risks are likely to come into effect nine months after financial market participants are required to disclose information on sustainability risks under the Regulation (EU) 2019/2088. This could have a significant impact on how firms ought to comply as these are interconnected initiatives. It is therefore vital that the scope and timing of each of the individual proposals work harmoniously with each other to progress this broad agenda. Ideally, the application date of the Regulation (EU) 2019/2088 would be deferred to align with these proposed amendments. If this is not a possibility, we would at least ask that the Commission take into account these sequencing issues when assessing the effectiveness of the different parts of the Action Plan. Only once the different parts of the Action Plan have had a chance to bed in and reinforce each other, will we be able to assess their effectiveness from a holistic point of view.

2. Sustainability risk assessment

Data challenges and the importance of qualitative assessment

As stated in the Regulation (EU) 2019/2088 Recital 15:
"This Regulation seeks to achieve more transparency regarding how financial market participants and financial advisers integrate sustainability risks into their investment decisions and investment or insurance advice. Where the sustainability risk assessment leads to the conclusion that there are no sustainability risks deemed to be relevant to the financial product, the reasons therefor should be explained. Where the assessment leads to the conclusion that those risks are relevant, ***the extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms****."*

We strongly support the approach whereby Firms should have the flexibility to conduct the risk assessment in quantitative and qualitative terms, as appropriate. It is particularly relevant in cases where appropriate and reliable data is limited and can only increase transparency through the overall process.

Furthermore, this approach echoes the European Central Bank draft guide on climate-related and environmental risks published in May 2020, where qualitative assessment is recognised as an intermediate step: *"The ECB expects institutions to assign quantitative metrics to climate-related and environmental risks, particularly for physical and transition risks. However, it also acknowledges that common definitions and taxonomies in these risk areas are still under development, and that qualitative statements can be used as intermediate steps while the institution is developing appropriate quantitative metrics."*

We would, therefore, welcome an added provision within the delegated acts to acknowledge the ability for firms to assess upfront and during the whole risk management process the sustainability risk either in qualitative or quantitative terms, in particular when appropriate and reliable data is not available.

Proposed changes to Delegated Regulation (EU) No 231/2013 as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers;

We suggest adding the following to Article 40 (5) *Article 40 (5)* *5. The risk management policy referred to in paragraph 1 shall be appropriate to the nature, scale and complexity of the business of the AIFM and of the AIF it manages.* **In the absence of either standardized, certified or audited data from issuers and in accordance with Recital 15 of Regulation (EU) 2019/2088, sustainability risks may be assessed by the Investment companies on a qualitative basis.**

Disproportionate emphasis on sustainability risk

We support the integration of sustainability risks alongside all relevant financial risks on an ongoing basis and as part of the conflicts of interest identification process.

Clearer definitions allow more informed decisions making for greater accountability for addressing sustainability risk, and it is necessary to ensure that these are embedded in processes, systems and internal controls of investment firms, and that technical capacity and knowledge is put in place to analyse those risks.

We are nonetheless concerned that the amendments require firms to consider sustainability risks disproportionately in comparison to other relevant, material investment risks such as credit risk, liquidity risk etc.
As sustainability risks need to be considered equally alongside other risks, we would suggest potentially adding more prominent details in the Recitals.

Proposed changes to Delegated Regulation (EU) No 231/2013 as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers;

We suggest deleting the added provisions in:

- Art 18 (5) which relates to due diligence
- Art 22 (3) which relates to Resources
- Article 30 which relates to conflicts of interest
- Article 57(1), which relates to General Organization of management companies
- Article 60(2) which relates to Senior Management

As well as amending Recital 3, as shown below:

(3) In March 2018, the Commission published its Action Plan 'Financing Sustainable Growth', setting up an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in the Action Plan is to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth. The impact assessment underpinning subsequent legislative initiatives published in May 2018 demonstrated the need to clarify that sustainability factors should be taken into account by Alternative Investment Fund Managers ('AIFMs') as part of their duties towards investors. AIFMs should therefore assess not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks as referred to in Regulation (EU) 2019/2088 of the European Parliament and of the Council that, where they occur, could cause an actual or potential material negative impact on the value of an investment. ~~*Commission Delegated Regulation (EU) No 231/2013 does not explicitly refer to sustainability risks. For that reason*~~ **AIFMs should, therefore, ensure that along with other risks, sustainability risk is considered as part of the AIFMs internal procedures and organisational arrangements, systems and internal controls, and that technical capacity and knowledge is appropriate to analyse those risks.**

3. Proposal to include principal adverse impacts in due diligence process

While sustainability risks should be considered in due diligence requirements, we are concerned about the introduction of a direct requirement to take into account principal adverse impact.

Misalignment with other regulations

As previously highlighted, it is vital that the scope and timing of each of the individual proposals work harmoniously with each other to progress this broad agenda. In this instance, the Regulation (EU) 2019/2088 obliges Managers required to consider principal adverse impacts of investment decisions on sustainability factors, or consider those principal adverse impacts voluntarily to disclose how their due diligence policies take those principal adverse impacts into account. The draft amendments, introduce a mandatory requirement to take into account principal adverse impacts in due diligence process, which goes further than the initial requirement to disclose these. It is even more concerning considering the Joint RTS on ESG disclosure standards for financial market participants text currently being consulted on wherein 34 indicators are being mandated at entity level.

Possible Conflict with Managers' duties to act in the best interests of clients

The mandatory consideration of principal adverse impact in due diligence process can be further challenged as it disregards the fact that sustainability preferences are not reflected in all investment strategies. Such integration would contradict the manager's duty to align with the objectives of the investors.

Proposed changes to Delegated Regulation (EU) No 231/2013 as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers;

We suggest adding a new Paragraph to Article 18, in lieu of paragraph 5, which was deleted as per changes above: "**5. Where AIFMs consider principal adverse impacts of investment decisions on sustainability factors as described in Article 4(1), point (a) of Article 4 of Regulation (EU) 2019/2088, or as required by paragraphs 3 or 4 of Article 4 of that Regulation, those AIFMs shall include considerations on principal adverse impacts when complying with the requirements set out in paragraphs 3 and 4 of this Article to the extent relevant to the strategy employed by a particular AIF."**

We would like to thank the Commission again for this opportunity to provide feedback on the draft amendments and hope our comments will positively contribute to the effort to include sustainability factors and risks considerations within existing Directives.