IA Response to the EU Renewed Sustainable Finance Strategy Consultation

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 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 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.

Collated Responses to the Survey Questions

A. INTRODUCTORY QUESTIONS "TARGETED AT EXPERTS"

Question 9:

As a corporate or a financial institution, how important is it for you that policy-makers create a predictable and well-communicated policy framework that provides a clear EU-wide trajectory on greenhouse gas emission reductions, based on the climate objectives set out in the European Green Deal, including policy signals on the appropriate pace of phasing out certain assets that are likely to be stranded in the future?

IA Response:

<u>5 – very important</u>

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 corporate and financial institutions.

B. CORPORATE DISCLOSURE

Question 14:

In your opinion, should the EU take action to support the development of a common, publicly accessible, free-of-cost environmental data space for companies' ESG information, including data reported under the NFRD and other relevant ESG data?

- *Yes/No/Do not know.*
- *If yes, please explain how it should be structured and what type of ESG information should feature therein. [BOX, 2000 characters]*

IA Response: Yes

There is a clear need to ensure greater consistency and comparability of ESG data. The starting point should be to encourage high-quality disclosures in line with global standards and frameworks. As we have set out in response to the Commission's consultation on NFRD, this should be achieved by the formal endorsement of global standards and frameworks, and we explicitly endorse SASB and TCFD. This will have positive impacts on the availability and quality of aggregated data.

Once there is confidence in the quality and comparability of these disclosures, digitisation will have the benefits of cost-saving for users and will enable investors to integrate ESG factors into their investment processes more readily. A single ESG access point made available on an open-source basis will make this information more accessible for a wider range of market participants. This may improve access for retail investors and other users that do not have resources available to commission specialist data providers. It may have the added benefit of boosting standards and competitiveness in the wider market for ESG data providers, allowing innovation in the use of this data.

Such a project should not be undertaken before there is confidence in the quality and consistency of issuer disclosures on non-financial matters. It should be focused on financially material information and as far as possible this data should be produced in a format that sits alongside and is readily comparable with financial information. This platform should be built around agreed standards that have global comparability – specifically SASB and TCFD. This database musn't create additional reporting or administration requirements for companies. This project will need to be well governed and have the buy-in of market participants.

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 17:
Do you have concerns on the level of concentration in the market for ESG ratings and data?
Please express your view by using a scale of 1 (not concerned at all) to 5 (very concerned). If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

IA Response: 3

There is a significant concentration in the market for ESG ratings as well as an increasing concentration in the market for providing underlying ESG data.

These are rapidly evolving industries responding to enhanced expectations and demand from investment managers. There are a number of new entrants to the ESG data market that are making use of machine learning and other technological developments to influence the shape of the overall market. They are responding to investors need to innovate and strengthen their investment analysis on ESG considerations. As this market develops it is important to ensure that providers are focusing on the full range of data points that are material to different companies and responding to client demand for tailored analysis of companies. Over consolidation in this market may result in too narrow a range of indicators.

We are also seeing consolidation in mainstream rating providers and a concern that over-dominance may distort the availability of ratings provided to the end consumer. It may be too early to call the level of concentration a significant problem – this transformation in services will take time to adjust. However, it will be important to monitor how this develops and particularly to

monitor whether innovations and an increase in competitiveness ensure value for money as any excess costs will ultimately be borne by the end client.
ESMA has continued to address similar concerns in the proxy advisory market under the implementation of the revised Shareholder Rights Directive, which has only recently come into effect. It will be important to review progress in this area and consider learnings for the broader set of ESG ratings and research providers.

Question 18:

How would you rate the comparability, quality and reliability of ESG data from sustainability providers currently available in the market?

Please express your view by using a scale of 1 (very poor) to 5 (very good).

If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

IA Response: 2

We have a number of concerns with the quality and reliability of ESG data from providers including:

- A lack of transparency and accountability of the methodologies used. This can result in a significant amount of errors concerning the factors deemed to be material for different companies, the relative weightings applied to those factors and how they are measured.
- Lack of internal consistency of methodology across sectors, and across historical data for particular companies.
- An overreliance on publicly available data such as news articles, or historic litigation cases, which may be misleading, not been subject to appropriate controls, or out of date. These may often not take into account the impact of remediation efforts undertaken by the company.
- Infrequent review cycles can result in out-of-date data.
- A lack of willingness to engage with the issuer, to better understand and assess publicly available data. Where engagement does take place, it is often done over a protracted period, meaning that the rating of the issuer may be inaccurate for a long-time while the engagement is taking place.
- There is poor coverage in emerging markets and private companies. Smaller companies, with less resource to produce this data may be inappropriately penalised.

Comparability between different data providers should not be an automatic expectation. Managers want to distinguish between the quality of data providers and select those with approaches that are most suitable for aligned to their approach to ESG integration and and investment beliefs.

Nonetheless, you would expect to see approximate comparability (i.e. not complete divergence) in the ratings of the same company by different providers. Many firms have found a limited correlation between the ratings provided by different rating providers and this anecdotal finding is supported by a number of pieces of research (research from CSRHub and the Massachusetts Institute of Technology (MIT)).

Question 19:

How would you rate the quality and relevance of ESG research material currently available in the market?

Please express your view by using a scale of 1 (very poor) to 5 (very good). § If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

IA Response: 3

While there have been significant improvements in the quality of ESG research material in the last five years, we still have a number of concerns as highlighted in response to question 18.

In practice, this means that there can be excessive costs and oversight processes involved in cleansing and verifying data before it can be usefully inputted into the investment process to the benefit of clients.

Question 20:

How would you assess the quality and relevance of ESG ratings for your investment decisions, both ratings of individual Environmental, Social or Governance factors and aggregated ones?

Individual: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good). Aggregated: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good). If necessary, please explain the reasons for your answer. [BOX, 2000 characters]

IA Response: 3 [for both individual and aggregate ratings]

Investment managers use ESG ratings and data for a number of purposes:

- To inform their investment decision making, i.e. active managers can use this information to influence their assessments of risk-adjusted return which can be both quantitative and qualitative.
- To inform their stewardship and engagement approach – this information can help to inform focused engagements on material issues.
- To inform their product development to ensure they are developing a range of products that meet demand from their clients for various sustainability characteristics across both active and index-based strategies.
- To communicate to clients and end beneficiaries about the sustainability characteristics of their portfolios.

Turning ESG information into readily quantifiable data that can be included in investment models is not the only purpose of this information. Investment managers also want to understand how companies are identifying the impact of ESG risks and opportunities on their business model and strategy, and how this features in their risk management, oversight and capital allocation plans.

This emphasis ensures a dynamic rather than static consideration of sustainability factors enabling focused engagement on how companies are making a sustainable transition.

While the quality of ESG ratings of individual factors for the purposes of making investment decisions is improving, aggregated data can be misleading. It is important, therefore, to ensure that investment managers are making clear disclosures to their own clients about the extent to which they are using these rating and data providers to inform their investment decisions. There should be more scrutiny, transparency and education to underlying consumers of these ratings and their methodologies as well as the wider qualitative use of this data, including for the purposes of engagement.

Question 21:

In your opinion, should the EU take action in this area?

IA Response: No

This is a developing market, which is responding to client demand to improve practices. It will be important to monitor how this market evolves to assess whether regulatory action is needed. In the first instance, there are a number of market-led developments that should be explored.

A key starting point for addressing these concerns is to improve the quality and comparability of issuer disclosures. As we have set out in response to the Commission's consultation on NFRD, this should be achieved by the formal endorsement of global standards and frameworks, and we explicitly endorse SASB and TCFD.

After establishing this consistency, the establishment of a central access ESG database may have the added benefit of boosting standards and competitiveness in the wider market for ESG data providers and allow innovation in the use of this data.

Direct regulatory action is not yet necessary but should be kept under review on the premise that market-led action to address these concerns to improve transparency and accountability is undertaken.

An initial area for market-led action would be for ESG data providers to work with their clients to develop a code of practice that ensures they are making transparent disclosures on:

- the governance and assurance of their products, including communication to clients about errors identified and the impact on historical and forward-looking data
- product development and investment in their teams and platforms
- how they manage conflicts of interest
- How they engage with investee companies to understand and assess information that is not reliably available publicly. They should establish and clearly communicate a clear process for issuers to engage with them on their ratings and to challenge them where necessary.

This will better enable investment managers to make informed choices about their choices in providers. This provides a reference point for managers in their due diligence when appointing and reviewing providers.

C. PRODUCT-LEVEL STANDARDS AND LABELS

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?

No regulatory intervention is needed.

The Commission or the ESAs should issue guidance on minimum standards.

Regulatory intervention is needed to enshrine minimum standards in law.

Regulatory intervention is needed to create a label.

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.

Question 29:

Should the EU establish a label for investment funds (e.g. ESG funds or green funds aimed at professional investors)?

IA Response:

<u>No</u>

We would not ask for the development of an EU ESG label right now. Labels can make it easier for investors to choose products, particularly in the retail market. However, they are not a panacea and do not replace the important work on disclosure of responsible investment characteristics at the fund level. Instead, they can provide a helpful shortcut, to be used alongside fund-level disclosures.

Furthermore, we would suggest taking a moment to assess the impact of new disclosure requirements under SFDR to communicate wider ESG criteria to investors before taking forward any new EU-wide broader ESG label.

There may be a time in the future, when an EU ESG label could help to bring clarity to consumers in a consistent way that is not nation-specific, but we don't see this moment being now. If the EU were to establish a label in the future, we would ask that it:

- Focus on retail investors;
- Cater to the wide range of preferences that different investors have
- Include not only bottom-up investee company-level data but also a top-down approach to consider the investment manager's processes;
- Broadly follow a similar approach to existing national labels so that firms can leverage the work already done on labelling their products to facilitate an easy adoption of the EU label.

The IA is in the process of creating a UK retail product label. This work seeks to bring clarity to retail investors and builds on the examples of existing labels. The label shall focus on a fund communicating its intentions clearly but shall not be prescriptive in the approach a fund must take.

D. CAPITAL MARKETS INFRASTRUCTURE

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

Please express your view by using a scale of 1 (strongly disagree) to 5 (strongly agree).

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 36:

In your opinion, should the EU foster the development of a sustainable finance-oriented exchange or trading segments that caters specifically to trading in sustainable finance securities and is better aligned with the needs of issuers?

IA Response: No

The IA strongly opposes the development of a sustainable finance-oriented exchange or trading segments.

Such exchanges or trading segments would serve only to fragment the market and bifurcate liquidity, further hampering the development of a strong sustainable securities market.

What is more, it would also serve to create a perception that any security not on those platforms is not sustainable. The IA believes strongly that sustainability should be an integral part of all investment decision-making, and the Commission should avoid creating the perception that this is an exception, rather than the rule.

E. SHORT TERMISM

Question 38:

In your view, which recommendation(s) made in the ESAs' reports have the highest potential to effectively tackle short-termism? Please select among the following options.

- *Adopt more explicit legal provisions on sustainability for credit institutions, in particular related to governance and risk management;*
- *Define clear objectives on portfolio turn-over ratios and holdings periods for institutional investors;*
- *Require Member States to have an independent monitoring framework to ensure quality of information disclosed in remuneration reports published by listed companies and funds (UCITS management companies and AIFMs);*
- *Other (Box max 2000 characters)*

IA Response:

<u>Other</u>

It will not be helpful to adopt any of these options at this time. We should allow recent regulatory changes to bed in to assess their effectiveness. As we set out in our response to ESMA's consultation on short-termism last year, portfolio turnover is not a helpful metric for assessing short-termism. ESMA concluded that it would be take no further action on this area at the current time.

It is important to distinguish between investments taking place over shorter time horizons, and 'short-termism'. The latter refers to behaviours which prioritises short-term interests and profit over long-term value. The former meets the needs of savers with shorter-term investment objectives or may be driven by the investment characteristics of the particular asset class under consideration. Different sources of capital have different recommended holding periods.

There are already provisions within the Shareholder Rights Directive II that allow asset owners to scrutinise their managers' approach to portfolio turnover and ensure their investment strategy is aligned with the profile and duration of their liabilities and how it contributes to the medium to long-term performance of their assets. This should result in greater transparency on how the investment strategy is meeting the investment objectives of the ultimate beneficiaries.

It is unclear what is meant by an 'independent monitoring framework to ensure quality of information published in remuneration reports'. In the UK, the IA produces yearly principles of remuneration to encourage alignment of directors' interests with the company's long term value creation. Shareholders hold companies to account on their adherence to these principles by voting on their remuneration report and policy at company AGMs. It is unclear what value a regulator led approach would have unless they have identified concerns with adherence to legislation.

Question 39:

Beyond the recommendations issued by the ESAs, do you see any barriers in the EU regulatory framework that prevent long-termism and/or do you see scope for further actions that could foster long-termism in financial markets and the way corporates operate?

IA Response: No

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 43:

Do you think voting frameworks across the EU should be further harmonised at EU level to facilitate shareholder engagement and votes on ESG issues?

IA Response: No

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 45:
Do you think that passive index investing, if it does not take into account ESG factors, could have an impact on the interests of long-term shareholders?

- *Yes/No/Do not know.*
- *If no, please explain the reasons for your answer if necessary. [BOX max. 2000*
- *characters]*
- *If yes, in your view, what do you think this impact is, do you think that the EU should address it and how? [box max. 2000 characters]*

IA Response: Yes

Index strategies, where asset allocation is driven by the constituents of their chosen index, do not have a role in allocation in the way active managers do; their role is typically focused on oversight, so as to protect and enhance the value of the index.

If ESG factors have not been accurately priced into market valuations, then index investors and their end beneficiaries may be inadvertently exposed to these. Active strategies are equally exposed where ESG factors are not properly taken into account.
Index investors do take account of ESG factors in a variety of ways, from investing in specific ESG indices to using their role as stewards to actively engage with investee companies to protect and enhance their value. As long-term holders of companies in the constructed index they use oversight, engagement and the exercise of voting rights to ensure the long-term quality and performance of the assets held. As holders in every company in a given index, index investors build long-term relationships and engage to enhance the sustainable value of companies in the index.

At this stage, there is no need for EU action in this area. Under the Shareholder Rights Directive II, there is now greater transparency of institutional investors' approach to integrating their engagement with their investment strategy, including engagement on material financial and non-financial factors and how the arrangements incentivises the manager to align its investment strategy and decisions with the profile and duration of the clients long-term liabilities. This transparency helps asset owners to hold their managers to account on how they are factoring ESG consideration into their investment process.

Index providers also play a role in capital allocation through the construction of indices. It will be important for them to respond to client demand with the construction of indices which incorporate ESG factors and ensuring that constituents of the index meet relevant ESG criteria on an ongoing basis.

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?

- *Yes, a more holistic approach should favor the maximisation of social, environmental, as well as economic/financial performance.*
- *Yes, as these issues are relevant to the financial performance of the company in the long term.*
- *No, companies and their directors should not take account of these sorts of interests.*
- *I do not know*

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 48:

Do you think that such a supply chain due diligence requirement should apply to all companies, including small and medium sized companies?

 Yes/No/Do not know.

 If yes, please select your preferred option:

o All companies, including SMEs.

o All companies, but with lighter minimum requirements for SMEs.

o Only large companies in general, and SMEs in the most risky economic sectors sustainability-wise.

o Only large companies.

IA Response: Yes

<u>All companies, but with lighter minimum requirements for SMEs.</u>

As per our response to NFRD, all companies should be required to report on material non-financial information, including in relation to supply chain due diligence. If these disclosures are based on frameworks and standards that have a firm emphasis on governance and materiality, this will ensure a proportionate approach. SMEs should therefore be able to opt into specific indicators that are most material to their business model.

With respect to supply chain due diligence specifically, more robust expectations of the largest companies should have positive flow-on effects for smaller companies in their supply chain.

F. RETAIL INVESTORS AND SUSTAINABILITY PREFERENCES

Question 49:

In order to ensure that retail investors are asked about their sustainability preferences in a simple, adequate and sufficiently granular way, would detailed guidance for financial advisers be useful when they ask questions to retail investors seeking financial advice?

Yes

No

Don’t know / no opinion / not relevant

IA Response: No

We agree that guidance for financial advisers would help inform the suitability process, help match investors' needs with the appropriate range of products and develop a consistent language across the distribution chain.

However, our members are conscious that such guidance will need to have a functional and relevant level of granularity that would be beneficial along the distribution chain. It should also be adjusted to cater for the different types of offering proposed by advisers, as we understand that it is not limited to single products, but can include a basket of assets within a portfolio.

To that effect, we would suggest for such guidance to be drafted at national association level, rather than at EU level. This would also facilitate the development of the guidance over time to the rapidly changing landscape with regard to sustainability-related product requirements.

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.

G. BROWN TAXONOMY

Question 82:

In particular, do you think that existing actions need to be complemented by the development of a taxonomy for economic activities that are most exposed to the transition due to their current negative environmental impacts (the so-called "brown taxonomy") at EU level, in line with the review clause of the political agreement on the Taxonomy Regulation?

Yes

No

Don't know/no opinion/not relevant

IA Response: No

We would not welcome the development of a Brown Taxonomy at this time. Developing any Taxonomy is challenging and there is still work to be done on the Green Taxonomy, including improving its ability to present a view of a company's future contribution to the Transition.

We also have concerns around thinking purely in terms of "green" and "brown" and would instead encourage thinking in terms of “facilitating the transition” to a low-carbon future. Investment managers exercise their role as stewards of their clients’ assets to engage with companies and encourage more sustainable business practices as well as holding those companies to account to this end. It is important that taxonomies can be used to demonstrate these kinds of dynamic changes, and that we do not focus wholly on the static picture of a fund's underlying holdings. We would therefore welcome a continued focus of ensuring the Green Taxonomy is able to encourage investment to facilitate the transition, before potentially looking to a Brown Taxonomy.

We support the Commission’s efforts to draw attention to the sectors, businesses and business activities that are likely to be harmful, and recognise that time is of the essence to do so. We would therefore welcome the Commission lending its support to existing initiatives to demonstrate global leadership in sustainable finance, specifically:

- The TCFD has already proposed a definition of carbon intense sectors that is used by some firms for disclosure;
- Work is ongoing in the UNEP FI pilot to develop a list of climate sensitive sectors that can be used for climate risk analysis;
- The PACTA methodology also identifies climate-relevant sectors and activities for alignment analysis.

Finally, we would note that subsidies for environmentally harmful activities (incl. fossil fuels) can be stopped without defining a full Brown Taxonomy. We stand ready to assist the Commission in helping to identify such activities and providing policy recommendations for action.

H. DUTIES TO ACT IN THE BEST INTERESTS OF CLIENTS

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 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 2021 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

I. PENSIONS

Question 92:

Should the EU explore options to improve ESG integration and reporting beyond what is currently required by the regulatory framework for pension providers?

IA Response: Yes

If yes, please specify what actions would be relevant in your view.

Consideration of financially material ESG factors is concerned with understanding how these factors (which include both risks and opportunities) may affect the risk and value of an investment portfolio. This is particularly important in the pensions sector as: (i) pensions are the main source of income in retirement for millions of people and a failure to consider ESG factors could have adverse consequences for retirees' living standards; (ii) the size of the European pensions sector - €4 trillion - and the decades-long time horizon over which it invests, means that its investments may be particularly exposed to risks arising from a failure to account for the impacts of climate change.

Investment rules on ESG integration in the IORP II Directive and the PEPP Regulation already allow for pension providers to take into account the potential long-term impact of investment decisions on ESG factors. However, EIOPA's own findings regarding the extent of ESG integration amongst IORPs show that the European pensions sector could go further.

This is an issue of practice rather than law, which could be addressed through the introduction of stronger governance requirements on pension providers. These could require providers to periodically consider and report on the impact of ESG factors on the risk and return of their portfolios, combined with practical guidance on issues to consider in relation to ESG integration. For example, requiring them to formulate and disclose their investment beliefs regarding ESG integration periodically, and subsequently reporting to supervisors and pension savers how those beliefs have been incorporated into investment strategies via annual implementation reports. These simple requirements will normalise ESG integration across the sector.

Question 93:

More generally, how can pension providers contribute to the achievement of the EU's climate and environmental goals in a more proactive way, also in the interest of their own sustained long-term performance? How can the EU facilitate the participation of pension providers to such transition?

IA Response:

Pension providers' main purpose is to deliver retirement income. In doing this, they can help the EU achieve its climate and environmental goals. As long-term investors, pension providers should consider and manage all financially material factors that will impact on the long-term risk-adjusted returns to their investments. Long-term climate change and the transition to a low carbon economy represent particular risks and opportunities for the sector because of the length of its investment horizon. The EU's intended direction on climate change mitigation and the greening of the European economy represent an opportunity for pension providers to position their portfolios to benefit, creating an alignment of interests with the EU.

As previously stated, there is scope for the EU to enhance governance requirements for pension providers on ESG integration, clarifying that all financially material ESG factors should be considered in the investment strategy. Climate change, and measures to mitigate its impact (including the transition to a low-carbon economy), could be specified as factors that pension providers must consider when formulating and implementing their investment strategies. This would formalise the alignment between beneficiaries' interests and the EU's long term environmental and climate goals.

The simplest way to achieve this would be to build on the existing work of the Taskforce on Climate-related Financial Disclosures (TCFD) and require EU pension providers to disclose in line with the TCFD's recommendations. These include a series of disclosures through which organizations can identify and disclose decision-useful information about material climate-related financial risks and opportunities. The recommendations cover asset owners, amongst others, and there is global support for the TCFD's recommendations from the pensions sector.

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.

J. NATURAL CAPITAL ACCOUNTING OR "ENVIRONMENTAL FOOTPRINT"

Question 98:

Are there any specific existing initiatives (e.g. private, public or other) you suggest the Commission should consider when supporting more businesses and other stakeholders in implementing standardised natural capital accounting/environmental foot-printing practices within the EU and internationally?

- *Yes/No/Do not know.*
- *If yes, please list a maximum of three relevant initiatives.*

IA Response: Yes

There is a clear need to standardise natural capital accounting/environmental foot-printing practices. The Commission should consider adopting approach that is applicable internationally and does not create fragmentation between the EU Member States and international markets. We therefore suggest that the Commission consider developing an approach around SASB, which already has an international reach and investor support. Crucially, SASB standards differ by industry. This allows for more appropriate accounting practices to be adopted and greater comparability between like-for-like companies.